SHIPBUILDING, REPAIR, AND FINANCING—PART 1

HEARINGS

BEFORE THE

SUBCOMMITTEE ON MERCHANT MARINE

OF THE

COMMITTEE ON
MERCHANT MARINE AND FISHERIES
HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

OVERSIGHT TO REVIEW THE STATUS AND STEWARDSHIP OF TITLE XI
OF THE FEDERAL SHIP FINANCING PROGRAM
AND
H.R. 1037, REQUIRING FEDERAL AGENCIES TO CHECK WITH MARAD
BEFORE PURCHASING VESSELS FROM PRIVATE COMPANIES

OCTOBER 15, 1987

OVERSIGHT ON THE REDUCTION IN U.S. SHIPBUILDING AND SHIP
REPAIR CAPABILITY

DECEMBER 8, 1987

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[1] Resigned from Committee on October 21, 1987.

[2] Resigned from Committee on November 4, 1987.

[3] Became a member of the Committee on November 4, 1987.

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THURSDAY, OCTOBER 15, 1987

House of Representatives,
Subcommittee on Merchant Marine,
Committee on Merchant Marine and Fisheries,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:20 a.m., in room 1334, Longworth House Office Building, Hon. Glenn M. Anderson (acting chairman of the subcommittee) presiding.

Present: Representatives Anderson, Biaggi, Tallon, Pickett, Thomas, Shumway, Bateman, Miller, Bentley, and Coble.

Staff present: Subcommittee on Merchant Marine—Cynthia M. Wilkinson, chief counsel; Lawrence G. Mallon, counsel; Ann M. Mueller, clerk; and Kip Robinson, minority counsel. Committee on Merchant Marine and Fisheries—John Cullather, staff assistant; John Moran, minority counsel; and Gwen Lockhart, chief minority clerk.

STATEMENT OF HON. GLENN M. ANDERSON, A U.S. REPRESENTATIVE FROM CALIFORNIA AND ACTING CHAIRMAN, SUBCOMMITTEE ON MERCHANT MARINE

Mr. Anderson. The meeting of the Subcommittee on Merchant Marine will come to order.

The Subcommittee on Merchant Marine convenes today for the third in a series of oversight hearings to review the status and stewardship of title XI of the Federal Ship Financing Program. We will also consider H.R. 1037, a bill that would require Federal agencies to first contact the Maritime Administration for vessels before purchasing them from private companies.

[Ed. note.—See Printed Hearings No. 99-24 for June 25 and October 3, 1985 hearings.]

Previous hearings have investigated the origins and causes of an unprecedented series of defaults and payouts on ship loan guarantees, now exceeding $2 billion. These defaults have resulted in the exhaustion of the Federal Ship Financing Fund and have necessitated direct Treasury borrowing.

Last year, the Merchant Marine Subcommittee was instrumental in exempting MARAD from the automatic stay provisions of the Bankruptcy Code. This exemption now permits MARAD to foreclose on assets pledged as security for Federal ship loan guarantees. We will inquire into the extent of MARAD's reliance on this extraordinary authority and its recovery rate to date.

We will likewise review the results of two recently issued reports concerning the title XI program. One was prepared by the Comptroller General at the subcommittee's request. The other report was prepared by the Office of the Inspector General in the Department of Transportation.

While each report is properly critical of MARAD's administration of the title XI program during the unprecedented crisis, the more recent GAO report leaves room for optimism that corrective measures are underway within MARAD. These measures should remedy many of the identified shortfalls in documentation and reporting, as well as in management, information, and control systems.

In addition, we will review current MARAD policies for disposition of assets seized. We will explore opportunities for disposition through interagency sale and the need for legislation such as H.R. 1037, introduced by my colleague, Mike Lowry.

Finally, we will inquire as to the status of pending applications for new loan guarantees and MARAD's current policy concerning approval of applications meeting risk guidelines now in force.

I emphasize that these hearings serve the continuing purpose of fulfilling the subcommittee's oversight responsibilities under House rules and reflect ongoing support for the title XI program. If areas of program improvement are identified, they will be actively considered. We are not so much interested in the status of individual companies which may be identified as having problem loans at this time, as much as we desire to accurately evaluate the status of the entire portfolio and the potential for future defaults.

Recent reports concerning conditions in the energy and agricultural sectors of the economy suggest a note of cautious optimism may be in order for the maritime industry as well. These indications suggest that we may have turned the corner in both the rate and overall volume of defaults and, if so, we may have weathered the crisis.

I look forward to hearing from our distinguished witnesses this morning on this critical topic. Do other Members have an opening statement?

Mr. **Bateman**. Mr. Chairman, I have none but I see that there is an opening statement on behalf of the gentleman from New York, Mr. Lent, and the gentleman from Michigan, Mr. Davis, and I ask unanimous consent that they appear in the record.

Mr. **Anderson**. I have the three statements here of Mr. Norman Lent, Mr. Robert Davis, and Mr. Biaggi. If there is no objection, all three of those will be made a matter of the record.

Mr. **Bateman**. Thank you, Mr. Chairman.

[The prepared statements of Mr. Lent, Mr. Davis, and Mr. Biaggi follow:]

Statement of Hon. Mario Biaggi, a U.S. Representative From New York and Vice Chairman, Committee on Merchant Marine and Fisheries

This hearing continues the subcommittee's oversight of the title XI Federal Ship Financing Program. As Chairman of this subcommittee, I initiated these hearings in the last Congress to determine the causes of the tidal wave of defaults, bankruptcies, and foreclosures that has engulfed the title XI program since 1985.

To date, the Federal Government has been required to pay $2 billion in principal and unpaid interest on guaranteed obligations, on which debtors from every sector of the maritime industry have defaulted. Many of those debtors have then, proverbially, "thumbed their noses" at the Federal Government and fellow taxpayers by seeking protection under the bankruptcy laws. Many of those same operators were initially structured as tax shelter investments with little previous experience or loyalty to the maritime industry. They continued to operate to prevent their tax-advantaged, financial house of cards from collapsing. In the process, they avoided debt service and protective payments to MARAD with virtual impunity, aided and abetted by a bankruptcy court system hostile to the proper function of traditional admiralty courts and remedies. As a result, the continued operation of those vessels, unburdened by capital cost contribution, further drove down freight and day rates on equipment. This, of course, exacerbated the depressed state of the maritime industry and, inevitably, contributed to additional defaults and bankruptcies.

The subcommittee has initiated several legislative actions to date in response to this crisis. We have reaffirmed our exclusive prerogative to set authorization ceilings on new loan guarantees to ensure that, while we work out the program's difficulties in the short term, no one—especially OMB—can arbitrarily shut the program down.

Indicative of how strongly we are committed to preserving this program, we suffered a presidential pocket veto of last year's MARAD authorization rather than knuckle under to the administration's demand to repeal MARAD's authority to enter into new loan guarantees.

Frankly, it would, in my judgment, be ludicrous to terminate the title XI program at a time when there are favorable indications of the need for a program to promote private capital investment in such sectors as the cruise and dredging industries. I want this hearing to send a clear and unambiguous signal that the title XI program is alive and well as a fundamental maritime promotion program.

Another purpose in holding this hearing is to review how MARAD is utilizing legislation I authored that permits the agency to avoid the automatic stay provisions of the Bankruptcy Code. I understand that bankruptcy courts are now applying this law, and that the mere existence of this authority constitutes significant new leverage in pre-default workout situations.

The recent General Accounting Office report on MARAD's performance in administering the title XI program demonstrates that MARAD has greater knowledge, and is exercising closer scrutiny and control over the portion of its guaranteed loan portfolio that is "troubled". I see signs that the program is getting back on an even keel. As vessel seizures, forfeitures, and sales begin to increase, I expect that the financial picture of the reserve fund will improve immeasurably before we next revisit the program.

Statement of Hon. Norman F. Lent, a U.S. Representative From New York and Ranking Minority Member, Subcommittee on Merchant Marine

Mr. Chairman, I am pleased that we are holding this hearing today on the implementation of the Federal loan guarantee program administered by the Maritime Administration to help in the financing for merchant vessels. We have been looking at this program and trying to solve the problems of the defaults under the loan guarantee program for quite some time. I hope that we have now arrived at a time when we can make some decisions with regard to the administration of this program and whether or not additional legislation is needed.

I am aware that considerable background work has been done by the Inspector General's Office of the Department of Transportation and, most recently, by the General Accounting Office. The recent GAO report quite thoroughly reviewed the internal problems of the administration of the program and, hopefully, will be the guide book for working our way through the administrative difficulties. I hope that the representatives of GAO can briefly highlight for us the key points in their recommendations.

With regard to H.R. 1037, the bill that Mr. Lowry, myself, Mr. Biaggi, and Mr. Davis introduced earlier this year, I believe this bill deserves serious consideration and expeditious movement. We should require Government agencies to look first at vessels being held by the Maritime Administration, or any other agency, before they proceed to spend taxpayers' money to build or buy new vessels. Indeed, several months ago we had a situation where the Panama Canal Commission could have used a couple of tugboats that MARAD had but there was considerable reluctance and delay and, as a result, I understand that the vessels ultimately were disposed elsewhere. I look forward to hearing from our witnesses as to whether we have fashioned proper legislation on this point.

I hope all of our witnesses will discuss the substantive ways in which we can assure that the title XI loan guarantee program can be continued and eliminate artificial barriers that are the result of internal financial difficulties or bookkeeping problems. After all, administrative difficulties should not decide the fate of a major Federal program designed to aid the maritime industry. We really should be trying to do something about the real problems—international trade, economic problems, and the availability of cargoes for U.S. vessels.

Thank you, Mr. Chairman.

STATEMENT OF HON. ROBERT W. DAVIS, A U.S. REPRESENTATIVE FROM MICHIGAN AND RANKING MINORITY MEMBER, COMMITTEE ON MERCHANT MARINE AND FISHERIES

Thank you, Mr. Chairman, I would like to thank you for holding this hearing on the Title XI Federal Ship Financing Program. This is not the first time this Congress that the Subcommittee has considered this subject. Once again this year, the Administration requested that the title XI program be discontinued. Once again, the Committee on Merchant Marine and Fisheries declined to honor that request. The title XI program plays an important role in promoting domestic ship construction. It is now the primary means of Federal assistance of commercial construction available to vessel owners and shipyards. It cannot be abandoned.

This is not to say that the title XI program is without problems. In the last several years, the program has experienced massive defaults and for the first time in its history is no longer self-supporting. The purpose of the hearing today is to study a couple of ways to improve administration of the title XI program and to assist the Maritime Administration in disposing of vessels in the title XI fleet.

Sometime ago, the Chairman of this Subcommittee requested a study by the GAO of the Maritime Administration's implementation of the title XI program. The GAO completed that study and forwarded their report to the Congress. The report suggests several ways in which the program may be more efficiently and rationally administered. I understand that MARAD has already implemented some of these suggestions.

H.R. 1037 would require Government agencies to look to the available vessels in the MARAD fleet before acquiring or constructing any new noncombatant vessels. Mr. Chairman, this bill seems to be a very good idea. It would save the Government money in the acquisition of vessels and allow the Maritime Administration to recover a portion of their losses. There are practical problems to be worked out. That is what we are here to explore today; but the idea is sound and bears looking at.

I would like to welcome the witnesses, and I look forward to hearing your testimony.

Mr. ANDERSON. Any further comments?

Mr. BATEMAN. I welcome the witnesses and wish that I would be able to stay throughout the meeting, but I have another conflict and will have to leave shortly, but welcome and thank you.

Mr. ANDERSON. This morning we are very pleased to have with us Mr. Kenneth M. Mead, the Associate Director of the Resources, Community, and Economic Development Division of the United States General Accounting Office. I believe he is accompanied by Mr. Frank Bowers, the Evaluator-in-Charge; and Mr. Raymond J. DiCarli, Assistant Inspector General for Auditing, Office of the Secretary of Transportation, accompanied by Joseph E. Kratz, Deputy Assistant IG.

We do have your prepared statements so they will appear in the record immediately following your oral presentation. You can read them, extemporize, any way you wish.

I will first call on Mr. Kenneth M. Mead, the Associate Director of the Resources, Community, and Economic Development Division of the United States General Accounting Office.

STATEMENT OF KENNETH M. MEAD, ASSOCIATE DIRECTOR OF THE RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION OF THE U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY FRANK BOWERS, EVALUATOR-IN-CHARGE

Mr. MEAD. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, we appreciate this opportunity to testify on our recent report on the Maritime Administration's Federal Ship Financing Program, which was done at the request of this subcommittee. Our work focused on the program's financial condition and certain data used to manage the program and report to Congress on the program's condition.

As the subcommittee is aware, the program is experiencing serious financial difficulties. This is due largely to economic conditions in segments of the maritime industry. By the end of fiscal 1985, the program was no longer self-supporting. This condition worsened in fiscal 1986 when default payments exceeded $1.2 billion, the highest level in the program's 15-year history. Default payments in fiscal 1987, however, have dropped dramatically from a year ago, but program revenues continue to be substantially less than those necessary to cover defaults.

We also identified problems with the completeness and accuracy of MARAD's program data. MARAD has since taken or plans to take actions to correct these problems. When these improvements are in place, the Congress and MARAD will have more useful and credible data on which to base key program decisions.

The program's outstanding loan guarantees were less than $2 billion at the end of fiscal 1973. They rose to a peak of about $8 billion in fiscal 1982, and declined to about $4.4 billion as of August, 1987. The expansion in the seventies and troubles in the eighties were due largely to the shipping fortunes of two industries, energy and agriculture.

Oil prices in the seventies led to a national effort to decrease dependence on imported energy sources. As part of that effort, MARAD extended loan guarantees for energy-related vessels such as drill rigs. During the same period, a significant increase in agricultural exports led to requests for guarantees to construct inland tugs and barges. However, a sharp decline in oil prices reduced the demand for drill rigs and other energy-related vessels, and agricultural exports were not sustained at the expected levels.

Buffeted by these forces, the program's financial condition changed dramatically. This was due to a surge of defaults during 1985 through 1987. Between 1972 through 1984, cumulative defaults were about $341 million. During 1985 through 1987, defaults were about $1.9 billion. Thus, about 86 percent of the defaults were reported in the past three years.

Although companies with vessels operating in all segments of the maritime industry suffered some defaults from fiscal 1985 to fiscal 1987, companies in the energy and agricultural segments accounted for about 68 percent of the total. These defaults have had an effect on the size and composition of the title XI portfolio. The total value of the portfolio declined from about $7.8 billion in 1983 to about $4.4 billion in August, 1987. Energy-related segments, again, were hit particularly hard.

For example, loan guarantees for drill rig vessels declined from nearly $1 billion to $228 million. Guarantees for drill supply vessels declined from $362 million to $74 million. Moreover, commitments to guarantee new loans steadily declined between fiscal years 1980 and 1985. There was a slight increase in fiscal 1986, but MARAD did not permit itself to issue any new loan guarantees in fiscal 1987.

The increase in defaults also has had repercussions for the program's budget. Fiscal 1984 was the last year revenues exceeded expenses and, in that year, by about $27 million. Expenses exceeded revenues by about $250 million in fiscal 1985, and about $755 million in fiscal 1986.

These shortfalls used up the surplus that the fund had accumulated over the years. MARAD, therefore, borrowed almost $1.4 billion from the Treasury by the end of fiscal 1986 to cover these shortfalls. Since the fund was not in a position to pay the money back, the Transportation Department requested, and Congress later approved, a supplemental appropriation of about $1.4 billion.

Another shortfall occurred this year. Through August, MARAD had received revenues of about $95 million but borrowed about $400 million to cover default payments and other expenses. Although default payments have dropped significantly from a year ago, revenues will not be sufficient to repay these borrowings. MARAD is seeking another supplemental to repay this debt.

In addition to the program's financial difficulties, we found several problems with financial reporting and program management data. These include inconsistencies in the value of loan guarantees and incomplete data on the extent of the portfolio at risk of default.

In fiscal year 1985, MARAD reported inconsistent data in its reports and other documents, one of which was sent to the Congress. These reports sometimes contained significant disparities in the number of vessels and value of MARAD's portfolio. Although these data are basic to program oversight, the discrepancies sometimes differed by up to $400 million. MARAD has since taken corrective action in this area and is now reporting consistent figures.

MARAD also reported a liability in its fiscal 1986 financial statements and budget documents for the amount of default payments it expected to incur in fiscal 1987. No such liability was shown for prior years, although generally accepted accounting principles for Federal agencies required one.

Our report recommended that MARAD document the process used for estimating the liability for potential defaults. MARAD has agreed to carry out this recommendation. This, we believe, will provide MARAD with an internal control to assure that the estimating process is working as intended.

We also recommended that MARAD's annual report clearly state that the fund is no longer self-supporting. This statement is needed, we felt, because revolving funds are intended to be generally self-supporting, rather than being maintained with Treasury borrowings that the fund cannot repay.

Since 1985, MARAD has not been able to repay its borrowings, relying instead on congressional appropriations. Therefore, we believe that MARAD's annual report should acknowledge its reliance on congressional appropriations by clearly stating that the fund is no longer self-supporting. MARAD officials have advised us that the 1987 annual report will contain such a disclosure.

The identification of companies with guarantees that are at risk of default is central to assessing how much of the portfolio is at risk. MARAD usually prepares a monthly report called the Credit Watch Report as a management tool to monitor companies judged to be at risk and their progress in overcoming financial difficulties.

Although MARAD officials initially told us that the report contained a complete list of companies at risk of default, we later learned that the report contains significant disparities and omissions. One report omitted 14 companies; another omitted 34. When the additional information was added, guarantees at risk of default increased from $939 million to $1.6 billion for November, 1985 and from $351 million to $954 million for December, 1986.

When we asked MARAD officials why they did not routinely compile complete data on companies at risk of default, they told us they were satisfied to rely on staff to provide data as needed. However, we believe the Credit Watch Report would be a more useful management tool if it reflected all of the companies and guarantees MARAD considers at risk of default.

The process by which the loan examiners determine that a company is at risk also needs to be documented. That will provide better assurances that judgments about the extent of the portfolio at risk, including needs for Treasury borrowing, are based upon complete and credible information.

MARAD officials recently advised us that a complete listing of companies at risk of default, together with information on their circumstances, has now been prepared. We will evaluate that listing to determine whether it complies with our recommendation.

Mr. Chairman, that concludes my testimony. I would be happy to answer any questions that you or other Members may have.

[The prepared statement of Mr. Mead can be found at the end of the hearing.]

Mr. ANDERSON. Thank you, Mr. Mead. We will hold the questions until after Mr. DeCarli has completed his testimony.

At this time, Mr. Raymond J. DeCarli, Assistant Inspector General for Auditing, the Office of the Secretary of Transportation. We do have your prepared remarks, Mr. DeCarli, so they will appear in the record. You can read, extemporize, present them any way you wish.

STATEMENT OF RAYMOND J. DeCARLI, ASSISTANT INSPECTOR GENERAL FOR AUDITING, U.S. DEPARTMENT OF TRANSPORTATION, ACCOMPANIED BY JOSEPH E. KRATZ, DEPUTY ASSISTANT INSPECTOR GENERAL FOR AUDITING

Mr. DECARLI. Good morning. My name is Raymond DeCarli. I am the Assistant Inspector General for Auditing, Department of Transportation. Mr. Chairman and members of the subcommittee, I appreciate the opportunity to be here today at your hearing on the title XI Federal Ship Financing Program. With me is Joseph Kratz, the Deputy Assistant Inspector General for Auditing.

My testimony this morning will focus on two of our audit reports dealing with the title XI program. The first report was issued in July, 1983 and the second report in September, 1986. The objective of both audits basically was to evaluate MARAD's administration and financial management of the title XI program.

Prior to 1980, the title XI program was financially stable and relatively few companies defaulted on loans. The program grew from about $2 billion in 1973 to more than $7 billion in 1980. About half the loan guarantees were associated with oil, liquid natural gas, and agricultural equipment. Depressed economic conditions in these industries in the 1980's, together with strong international competition in the maritime industry, increased the potential for defaults on these loans.

MARAD's loan portfolio is now valued at about $4.4 billion. The decrease in the value of the guaranteed loans from the 1980 level was due to the normal completion of loans and to loan defaults. In the mid-1980's, the program sustained more than $2 billion of defaults.

Our 1983 report was the first indicator that the title XI program had the potential for serious financial problems. Of the $8 billion of outstanding loan guarantees and commitments, MARAD considered a number of companies with a total guaranteed debt of about $900 million to have a greater loan default risk than other title XI companies. Some of these companies had already received fund advances or additional loans to prevent default. There was a real potential for some defaults to occur from this group. However, at the time only about $200 million was readily available from the title XI revolving fund to cover the defaults.

In the past, MARAD had been able to preclude defaults by assisting companies to reorganize or liquidate their assets, and to prevent defaults through a series of cash advances. At the time of our audit, conditions in the maritime industry had reached a point where MARAD postponed repayment of some of the advances, and additional advances were made to cover interest payments on outstanding loans.

While unfavorable economic conditions were a major contributor to the title XI problems, some of MARAD's policies were also partially responsible. MARAD had approved loan guarantees to companies in questionable financial condition, guaranteed loans in segments of the maritime industry which were already overbuilt, and shifted the program emphasis away from deep water vessels to oil drilling rigs and inland river barges.

Our primary recommendation was that MARAD thoroughly reassess the title XI program. We wanted MARAD to strengthen its criteria for approving the loan guarantees by considering both the financial stability of the applicant and the economic condition of the maritime industry.

The MARAD Administrator at the time did not believe that the $900 million of loan guarantees cited in our report represented a good estimate of title XI loan defaults that would occur. He said such a loss was pessimistic and only conceivable under the assumption that recovery from the economic downturn would be delayed over a long period.

However, the Administrator agreed with our recommendations and advised that title XI regulations would be strengthened and firmer criteria would be established for approving loan guarantees. He also indicated that program priorities and goals would be clearly established regarding the types of vessels that would be funded. MARAD has since revised its loan approval procedures, but we have not evaluated the new procedures. As you know, MARAD has not approved any loan guarantees since late in fiscal year 1986.

Our 1986 audit report concentrated on the financial condition of the title XI program and the adequacy of decisions to provide assistance to financially troubled companies. We reported that the financial condition of the title XI program had worsened since our prior audit in 1983.

The Federal Ship Financing Fund did not have sufficient funds to support title XI ship loan guarantees. Changes in market conditions reduced demand for services which, in turn, increased the number of guaranteed loan defaults.

MARAD, acting in accordance with its authority, borrowed significant amounts from the Treasury, and the need for such borrowing steadily increased. As of December 31, 1985, MARAD had borrowed $450 million from the Treasury to meet obligations, with another $800 million anticipated to cover additional fiscal year 1986 defaults. By the end of fiscal 1986, interest expense for the fund exceeded projected revenues. MARAD continued to increase the fund balance through borrowing which the fund did not have the resources to repay.

We recommended that MARAD request an appropriation from Congress to liquidate the debt owed to the Treasury. We also recommended that MARAD make annual projections of the fund's revenues and expenses and request appropriations for any anticipated shortfalls.

MARAD, in response to the report, advised us that they were working with the Department of Transportation budget personnel to resolve the fund's financial problems. Subsequently, MARAD requested and Congress appropriated $1.4 billion to cover title XI defaults. As of September, 1987, MARAD has borrowed an additional $420 million from the Treasury to cover defaults, and intends to seek appropriations to cover the amount borrowed from the Treasury.

When a company is unable to generate sufficient cash to pay operating costs, debt service, and title XI loan guarantee fees, MARAD often attempts to restructure or reschedule the terms and conditions of the loan. These actions are commonly called workouts. A workout is done to facilitate repayment and to meet the requirements of the lending institution.

The most common workouts include the deferment of principal amortization payments and the use of title XI reserve funds to pay for title XI debt servicing. Other workouts have included the lowering of bond interest rates, transferring vessels and related indebtedness, obtaining indirect loans by subordination of MARAD's prime lien position, and deferring collection of MARAD loan fees and advances.

We reviewed workouts and found that they had not been effective in keeping maritime companies from defaulting on loans. MARAD officials approved workouts, although they were not always provided pertinent information concerning the available alternative actions and their related costs.

Our review of 21 companies that had workouts during the 15-month period ending October 31, 1985 showed that 11 of the 21 firms subsequently defaulted. The 21 firms had guaranteed loans of $790 million. The amount of defaults related to the 11 companies totaled over $279 million or about 35 percent of the total guaranteed amount. We anticipated that, unless market conditions improved, eight more firms would probably default between fiscal years 1986 and 1988.

Some of the workouts subordinated the Government's first claim to assets and had the potential to increase losses to the fund by about $20 million. These workouts were arranged prior to August 24, 1984 when the Office of Management and Budget issued revised Circular A-70. The revised circular required that the Government's claim on assets must not be subordinated to other lenders in the case of a borrower's default on either a direct loan or a guaranteed loan.

We recommended that MARAD document its cost analyses for workouts and consider the potential cost to the fund, as well as alternatives and market conditions, in their decision process. While MARAD agreed with the recommendation, they maintained that it had always been their practice to document cost, market conditions, and alternatives associated with any workout request.

We also recommended that MARAD stop approving workouts in cases which subordinated the Government's first position to participate in the proceeds from the sale of assets from defaulted loans. MARAD officials properly noted that they had not agreed to any workouts that resulted in subordinating the Government's claim to assets after the revised circular was issued.

Mr. Chairman, this concludes my prepared statement. I will be happy to answer any questions that you or members of the subcommittee may have.

Mr. ANDERSON. Thank you, Mr. DeCarli.

My first questions will be directed to the GAO and my second ones will be for the Inspector General.

Mr. Mead, your draft comments on H.R. 1037 raise possible constitutional objections to GAO's certifying the suitability or unsuitability of vessels available for MARAD prior to outside procurement. Now, if the OMB were substituted for the GAO, would this alleviate your objection?

Mr. MEAD. That would be preferable, yes, for a central management agency. The GAO's reservation was essentially that we ourselves are a legislative agency, and this particular function would seem to be a good idea. It would seem more appropriately an executive line function.

Mr. ANDERSON. Could you provide the subcommittee with a breakdown of the various sources of revenue to the Federal Ship

Financing Fund? You could do that for the record if it would be easier.

Mr. **Mead**. Yes. I can give you an overall summary now, if you wish.

Mr. **Anderson**. If you want to make it kind of overall, and then give us an item by item breakdown for the record.

Mr. **Mead**. Fine. This past year, from sales of vessels in their inventory they had about $52 million; from guarantee fees about $24 million; about $7 million on payments from defaulted loans; $4.2 million in paybacks on advances. I think what is interesting about those figures is the heavy reliance not so much on guarantee fees but on sales of vessels that are in MARAD's inventory. We will provide a more detailed statement for the record, as you requested.

[The information follows:]

FEDERAL SHIP FINANCING FUND-MONTHLY ACCOUNTING

	CASH ACCOUNT					TREASURY BORROWING & INTEREST ACCOUNTING						
MONTH END	ADJ. RECEIPTS (1)	TREAS. INTEREST, ADVANCES, PREM.-FEE REFUNDS,OTHER NON-VSL EXPENSES	O & T (2)	VESSEL EXPENSES-MARAD & COMPANY OWNED (3)	CASH BALANCE (4)	TREASURY BORROWING-MONTH (5)	TREASURY BORROWING-TOTAL (NET)	DEFAULTS PAID, (INCL INT.) FROM TREAS. BORROWING	UNUSED CASH TREASURY BORROWING (6)	TREASURY ACCRUED INTEREST -MONTH	TREASURY INTEREST CASH PAYMENT	TREASURY ACCRUED INTEREST -TOTAL
SEPT 1986	BALANCES FORWARD				51,569,011.95		1,375,000,000		12,753,509.02			52,420,381.52
OCT. 1986	5,033,316.42	42,424,930.38		591,917.41	13,585,480.58	10,000,000	1,385,000,000	17,939,640.23	4,813,868.79	10,278,422.01	-52,420,381.52	10,278,422.01
NOV. 1986	8,837,207.46	113,649.66		306,554.91	22,002,483.47	25,000,000	1,410,000,000	29,631,199.22	182,669.57	10,005,725.64		20,284,147.65
DEC. 1986	3,078,101.59	53,488.23		907,542.97	24,119,553.86	10,000,000	1,420,000,000	8,139,813.67	2,042,855.90	10,422,739.58		30,706,887.23
JAN. 1987	5,275,223.52	681,164.08	977,082	634,875.96	27,101,655.34	30,000,000	1,450,000,000	30,250,970.60	1,791,885.30	10,532,760.14		41,239,647.37
FEB. 1987	14,037,431.04	12,500.00	517,888	934,646.88	39,674,051.50	40,000,000	1,490,000,000	40,753,417.51	1,038,467.79	9,651,513.76		50,891,161.13
MAR. 1987	-5,541,703.60	913,115.40		1,103,641.27	32,115,591.23	200,000,000	1,690,000,000	159,967,796.19	41,070,671.60	11,436,863.82		62,328,024.95
APR. 1987	8,505,541.69	22,684,422.09	3,520	1,047,163.39	16,886,027.44	0	1,690,000,000	40,585,188.12	485,483.48	11,722,249.98	-62,328,087.18	11,722,187.75
MAY 1987	11,114,458.52	1,534,182.44	631,450	891,661.85	24,943,191.67	5,000,000	1,695,000,000	877,148.36	4,608,335.12	12,062,469.05		23,784,656.80
JUNE 1987	5,568,152.61	-192,950.60		1,409,679.41	29,294,615.47	35,000,000	1,730,000,000	35,096,762.47	4,511,572.65	11,799,954.75		35,584,611.55
JULY 1987	9,248,083.07	3,862,397.54		855,521.96	33,824,779.04	-1,345,000,000	385,000,000	30,000,000.00	4,511,572.65	5,687,433.75	-33,862,397.54	7,409,647.76
AUG. 1987	30,164,396.73	61,794.53	816,701	2,161,239.69	60,949,440.55	15,000 000	400,000,000	19,009,009.60	502,563.05	2,200,119.55		9,609,767.31
SEPT 1987	9,454,239.29	3,345,051.07		1,211,015.51	65,847,613.26	20,000,000	420,000,000	18,719,835.25	1,782,727.80	2,129,735.43		11,739,502.74
TOTALS	104,774,448.34	75,493,744.82	2,946,641	12,055,461.21		-955,000,000		430,970,781.22			-148,610,866.24	
LESS:												
FY 86 APP.		-42,420,381.52	-977,082	-293,607.53				-8,787,513.66			52,420,381.52	
FY 87 APP.EXPENDED		33,073,363.30	1,969,559	11,761,853.68		-955,000,000.00		422,183,267.56			-96,190,484.72	

(1) ADJUSTED RECEIPTS FROM PAGE 2 OF THIS REPORT.
(2) ADDITIONAL O & T CHARGED TO VESSEL EXPENSES ACCORDING TO MAR 500.
(3) CUSTODIAL EXPENSES ON DEFAULTED VESSELS.
(4) CASH BALANCE IN FEDERAL SHIP FINANCING FUND-TREASURY SCHEDULES ALSO INCLUDE UNUSED BORROWING [SEE (6)].
(5) MONTHLY BORROWING FROM TREASURY FOR DEFAULTS & INTEREST-NEGATIVE AMOUNT IN JULY REPRESENTS $1.375 MILLION APPROPRIATION LESS $30 MILLON BORROWED.
(6) TREASURY BORROWING LESS DEFAULTS PAID EQUALS THIS ACCOUNT.

Source: Maritime Administration

TITLE XI CASH RECEIPTS SUMMARY

	NET RECEIPTS	FEES INVESTIGATION, GUARANTEE,OTHER	PRINCIPAL PAID, NOTES RECEIVEABLE	INTEREST PAID, NOTES RECEIVEABLE	CHARTER HIRE (1)	ADEQUATE PROTECTION	SALES OF VESSELS OR ASSETS OWNED (MARAD)(2)	SALES OF VESSELS OR ASSETS UNOWNED (3)	PAYMENTS ON DEFAULTED LOANS	PAYMENT-MARAD EXPENSES	DEFERRED CREDIT-IN (4)	DEFERRED CREDIT-OUT (5)	FUNDS PAID TO OTHERS (6) (NON-ADD ACCOUNT
BALANCES											0.00		
OCT. 86	5,033,316.42	2,836,862.01	329,906.79	123,690.53	70,098.00	174,657.33	1,011,000.00	0.00	19,846.68	2,895.08	464,360.00	0.00	0.00
NOV. 86	8,837,207.46	3,469,249.68	258,681.68	28,911.49	104,227.98	180,406.66	4,928,600.00	0.00	234,988.87	0.00	783,898.22	-1,151,757.12	687,397.12
DEC. 86	3,078,101.59	1,702,525.36	111,954.52	113,120.97	93,000.00	180,406.66	813,565.07	0.00	112,530.11	0.00	27,500.00	-76,501.10	
JAN. 87	5,275,223.52	1,942,543.33	323,201.71	317,624.62	533,403.12	220,000.00	495,378.11	0.00	1,469,593.22	0.00	20,979.41	-47,500.00	
FEB. 87	14,037,431.04	1,117,181.46	1,711.81	45,395.34	42,000.00	533,215.41	0.00	1,577,928.00	91,978.43	0.00	10,649,000.00	-20,979.41	20,979.41
MAR. 87	-5,541,703.60	1,153,070.37	1,721.98	15,169.92	46,500.00	172,856.67	2,691,000.00	0.00	1,604.03	847,873.43	42,500.00	-10,514,000.00	10,300,000.00
APR. 87	8,505,541.69	2,336,765.92	481,139.41	158,773.90	215,009.00	265,558.17	1,395,000.00	2,330,707.60	1,341,680.72	0.00	115,906.97	-135,000.00	
MAY 87	11,114,458.52	2,452,241.88	585,362.92	147,122.05	46,500.00	249,299.77	2,217,600.00	1,558,000.00	3,216,911.90	18,750.00	717,070.00	-94,400.00	
JUN. 87	5,568,152.61	2,364,545.02	457,225.66	216,325.17	45,000.00	742,605.00	1,410,000.00	185,000.00	105,839.65	48,926.20	21,185.91	-28,500.00	
JUL. 87	9,248,083.07	2,340,611.71	1,697,385.90	529,230.38	524,836.39	471,112.50	800,000.00	0.00	301,066.19	20,250.00	2,563,590.00	0.00	
AUG. 87	30,164,396.73	1,363,841.31	22,786.99	49,677.24	14,000.00	72,862.50	5,679,110.00	25,300,000.00	7,162.55	3,002.05	514,830.00	-2,862,875.91	266,942.16
SEP. 87	9,454,239.29	1,765,897.00	972,864.31	74,891.49	30,000.00	108,346.37	1,882,000.00	2,734,660.94	200,673.36	1,499,753.82	421,052.00	-235,900.00	1,230.00
TOTALS	104,774,448.34	24,845,335.05	5,243,943.68	1,819,933.10	1,764,574.49	3,371,327.04	23,323,253.18	33,686,296.54	7,103,875.71	2,441,450.58	16,341,872.51	-15,167,413.54	11,276,548.69

(1) CHARTER HIRE---NEGOTIATED CHARTER HIRE OF VESSELS OWNED BY MARAD.
(2) SALE OF MARAD OWNED ASSETS---THESE SALES ARE OF ASSETS TO WHICH MARAD HAS TAKEN TITLE.
(3) SALE OF ASSETS UNOWNED BY MARAD---THESE ARE ASSETS NEVER TAKEN TITLE TO BY MARAD, BUT MARAD ARRANGED FOR THEIR SALE.
(4) DEFERRED CREDIT-IN---REPRESENTS RECEIPTS NOT YET OR MAY NEVER BE MARAD´S; SUCH AS: DOWNPAYMENTS, INSURANCE PROCEEDS, ETC.
(5) DEFERRED CREDIT-OUT--REPRESENTS DISTRIBUTION FROM THIS ACCOUNT, EITHER TO TRUSTEES, OTHER MARAD CATEGORIES, ETC.
(6) RETURNED NON ADD-DEFERRED CREDIT FUNDS DISTRIBUTED TO OTHER THAN MARAD RECEIPT ACCOUNTS.

Source: Maritime Administration

Mr. ANDERSON. Can you describe how the cycle of direct borrowing by MARAD for default payouts, followed by liquidating appropriations to repay the Treasury, operates?

Mr. MEAD. Could you restate the question?

Mr. ANDERSON. Yes. Can you describe how the cycle of direct borrowing by MARAD for default payments, followed by liquidating appropriations to repay the Treasury, operates?

Mr. MEAD. Yes. In general terms, when MARAD realizes it does not have enough funds, it will notify the Treasury of that. The Treasury, by law, since the guarantees are backed by the full faith and credit of the United States, will transfer that amount into the fund so that the fund can cover the default. MARAD, the fund, is supposed to eventually pay back both the interest on the amount borrowed as well as the principal sum borrowed. We can provide you a more detailed elaboration on that for the record, if you wish.

Mr. ANDERSON. What is the composition of the current $4 billion guaranteed loan portfolio by the industry?

Mr. MEAD. Liners comprise about 12 percent of the portfolio. Bulk vessels such as tankers, LNG's, comprise about 48 percent—pardon me—a little over 50 percent. Drill rigs are now down to 5 percent. Drill supply vessels are now down to 2 percent. Inland and coastal vessels combined constitute about 17 percent, and in a miscellaneous category about 6 percent. There has been a sharp decline in the percentage of the portfolio that is comprised of drill rigs and drill supply vessels.

Mr. ANDERSON. Have the number of troubled loan guarantees as a percentage of the entire guaranteed loan portfolio declined?

Mr. MEAD. Yes, they have. We would want to be cautious, though, before we took the fact of a decline over the past year and represented that as a trend.

Mr. ANDERSON. And are the absolute number of defaults or troubled loans on the decline?

Mr. MEAD. Yes.

Mr. ANDERSON. Could I have the number?

Mr. MEAD. Basically we had 20 percent of the portfolio last year in a seriously troubled category. At this point, or at the close of fiscal 1987, MARAD's data was showing about 11 percent in dollar terms. That is a dramatic drop. We have not validated that latter figure.

Mr. BIAGGI. Would the gentleman yield?

Mr. ANDERSON. Yes.

Mr. BIAGGI. I keep hearing decline, and what puzzles me or at least the question that comes to my mind is, is this decline the result of MARAD having dealt with the worst of the troubled loans, or are we talking about a reversal in overall economic condition for the positive?

Mr. MEAD. Clearly, the weakest companies have been cleaned out of the portfolio. Once a company defaults, its loan guarantee is no longer outstanding and thus doesn't constitute a part of that portfolio.

Mr. BIAGGI. But we have no reason to be optimistic?

Mr. MEAD. I think there is some, we believe that there is some hope.

Mr. BIAGGI. Based on what?

Mr. MEAD. The concentration in the portfolio, particularly of energy vessels, is declining. You will have a more diversified portfolio, less specialized vessels which are, therefore, less vulnerable to quick swings in the market. There are still a good number of troubled loans in this portfolio, though, and this is a volatile market. That is why I say that, while we have had a decline and it has been a substantial one and certainly is a harbinger, we think, of hope, we don't want to say yet that it is a trend. Things could change. Things could change quickly.

Mr. BIAGGI. We still have weak companies, and some companies becoming weaker.

Mr. MEAD. Yes.

Mr. BIAGGI. So, really what we are looking at is, we have just about eliminated most of the weaker companies from the portfolio, and that is why there is a decline in defaults. We don't have that many companies left to default.

Mr. MEAD. I don't know if I would go that far.

Mr. BIAGGI. I believe I am on the right track, though, aren't I?

Mr. MEAD. Yes.

Mr. BIAGGI. That's what I wanted to know. I would have preferred to hear you say no, the companies are stabilizing, they are strong, and that is the principal reason for the decline in defaults.

Mr. MEAD. Well, we would like to come here today and say the worst is over and we are clearly on an upswing. We are not——

Mr. BIAGGI. Well, I think you could say that, that the worst is over because you have buried most of the companies. They are gone.

Mr. MEAD. Well, that is one way of looking at it.

Mr. BIAGGI. Okay. Thank you.

Mr. ANDERSON. Can you provide an overview of the current status of the loan portfolio by industry segment, characterizing what portion of the portfolio would fall into a minimal, moderate, or serious risk category?

Mr. MEAD. Yes, and I would like to preface my response to that question——

Mr. ANDERSON. And if you want to do these afterwards for the record, it's all right, too. In other words, I don't want to——

Mr. MEAD. Yes, I can give you a quick overview.

Mr. ANDERSON. Good.

Mr. MEAD. I would like to preface the response to your question, Mr. Chairman, with a compliment to MARAD. A year ago, it would have been quite difficult to give you this type of breakdown. I think a lot of corrective action has occurred in the past year and, based on the data MARAD is now reporting, we are in a position to give you a breakdown with some descriptive clarity.

In 1986, 20 percent or $1 billion of this portfolio was judged to be at serious risk of default. What that means is that MARAD was judging that you had a substantial likelihood of default in the next 12 months. That figure is now down, by MARAD's figures, to 11 percent or about $475 million of the remaining $4.4 billion in the portfolio. Drill rigs, LNG's and drill supply comprise about 53 percent of the companies remaining in that category.

Now MARAD is now classifying its portfolio into three categories: minimal risk, moderate risk, and serious risk. The moderate risk category is defined as those companies that may have problems in 12 to 24 months. The moderate and serious risk categories comprise about 57 percent of the companies remaining in the portfolio or about $2 billion of the remaining $4.3 billion. That is why I danced around in response to Congressman Biaggi's question on where we were headed.

Mr. BIAGGI. You just gave me the answer.

Mr. MEAD. Minimal risk, which is a different way of looking at things, 42 percent of the 232 companies are judged at minimal risk. That is 55 percent of the total outstanding loan guarantees in real dollar terms.

Mr. ANDERSON. That only leaves 1 percent, then, in the serious risk category?

Mr. MEAD. Oh, no. I had combined the moderate and the serious.

Mr. ANDERSON. I see. When you gave me the 57 percent answer, that included moderate and serious?

Mr. MEAD. Yes.

Mr. ANDERSON. I see. Okay. What is the worst case scenario in terms of potential cumulative defaults under the title XI program?

Mr. MEAD. I don't have the answer to that question, Mr. Chairman.

Mr. ANDERSON. Okay. Then I will go to the next gentleman.

Mr. BIAGGI. Would the gentleman yield?

Mr. ANDERSON. Sure.

Mr. BIAGGI. On the basis of your recent figures of 56 percent of the portfolio representing moderate-to-severe risk, at this point it would be reasonable to assume the worst case scenario would be 56 percent or more than $2 billion lost in additional defaults could occur. After that, we should have a very precipitous decline in defaults.

Mr. MEAD. Yes, one would hope, unless the minimal risk category moves into a moderate or worse category.

Mr. BIAGGI. Well, then they are not so minimal. You had better put them into the moderate category.

[Information submitted follows:]

OUTSTANDING TITLE XI DEBT
BY SEGMENT & RISK CODE
Thousands of Dollars

As of August 31, 1987

Industry Segment	Minimal Risk			Moderate Risk			Serious Risk			Total All Risks		
	Number	Amount Outstanding	Share	Number	Amount Outstanding	Share	Number	Amount Outstanding	Share	Number	Amount Outstanding	Share
(1) Liner	4	$323,242	13.3%	8	$ 175,591	12.0%	5	$ 47,057	9.9%	17	$ 545,890	12.5%
(2) Bulk	43	$1,554,323	63.8%	34	$728,471	49.7%	7	$240,103	50.5%	84	$2,522,897	57.6%
Tanker	33	$870,563	35.7%	22	$460,505	31.4%	3	$64,946	13.7%	58	$1,396,014	31.9%
OBO/Dry B. a/	2	$65,250	2.7%	12	$267,966	18.3%	3	$50,157	10.6%	17	$383,373	8.8%
LNG	8	$618,510	25.4%	0	$0	0.0%	1	$125,000	26.3%	9	$743,510	17.0%
(3) Drill Rig	1	$7,543	0.3%	7	$108,014	7.4%	9	$112,428	23.7%	17	$227,985	5.2%
(4) Drill Supply	0	$0	0.0%	6	$57,781	3.9%	4	$15,838	3.3%	10	$73,619	1.7%
(5) Inland	14	$134,454	5.5%	25	$150,113	10.2%	6	$59,628	12.6%	45	$344,195	7.9%
(6) Coastal	24	$242,629	10.0%	15	$137,986	9.4%	0	$0	0.0%	39	$380,615	8.7%
(7) Other	13	$175,878	7.2%	7	$106,930	7.3%	0	$0	0.0%	20	$282,808	6.5%
Totals	99	$2,438,069	100.0%	102	$1,464,886	100.0%	31	$475,054	100.0%	232	$4,378,009	100.0%

a/A dry bulk carrier that transports oil and different types of ore (coal, iron, etc.).

SOURCE: Maritime Administration

Mr. Anderson. Mr. DeCarli, can you elaborate on your explanation of alternative forms of workout strategies used by MARAD in response to defaults under the title XI program?

Mr. DeCarli. Yes, sir. When a company that has a guaranteed loan is in a position where it doesn't have sufficient funds to pay its debt, the company is really faced and MARAD is faced with one of two situations: either allow the company to default, or they can find a way to keep the company in business. MARAD usually takes an optimistic view of the market, looking for the market to turn around, and it is to their advantage if in the long term they can keep the company viable, where they don't have to pay the default. That would be clearly the best alternative.

So, in order to accomplish that objective and keep the company going, there are really only two things you can do. You can reduce the amount of the current expenditures, or you have to increase the availability of capital to the company. Well, to reduce the expenditures a couple of things can be done. One of them is to work with the bondholders and try to work out a deal where they are willing to accept interest payments only for a while and defer the payments of principal. Another alternative is, if there has been a change in the economy, and the bond was set up at a high interest rate and the current interest rates are lower, MARAD will then try to negotiate, work with the company to get a lower interest rate and that will decrease the cost, the current cost. Another alternative is to try to refinance the debt.

On the other side of the coin, in terms of increasing the funds available to the company, a couple of the options are to allow the company to sell some of the assets and get capital to pay the debt, or to allow the company to reduce some of its contingency reserves. Basically that is the kind of workouts that MARAD will get involved in.

Mr. Anderson. Are you aware of any formal MARAD policies concerning workouts?

Mr. DeCarli. No, I am not, sir.

Mr. Anderson. Now, relatively speaking, in your judgment, which of these approaches pose more or less risk to the Government in individual workout situations?

Mr. DeCarli. I think the options of deferring the interest rates and the principal, the payment of principal, and trying to get a lower interest rate are the better options for the Government. They involve the least risk, and the amount of payout that the Government would have to make in case of default would not change. When you allow the company to sell off assets and to reduce those contingency reserves, it obviously weakens the financial structure of the company.

All of the alternatives are going to fail, realistically, unless the market turns around and the company is able to generate additional capital. In the event that the company ends up defaulting on the loan, MARAD's costs will probably be higher after the workout has happened. The reason the costs will be higher is because the company was allowed to stay in business for a longer period of time. It used the assets during that period of time, it used the vessel, and the normal depreciation on the vessel would reduce its value.

You also have a situation where you are dealing with a company who has financial problems, and it is likely that some of the required maintenance and those kinds of things won't be performed to save capital, and that will also have a detrimental effect on the asset value. And the third situation you have is, the company will have the opportunity to sell off some of its assets to pay back some of the costs that it is going to incur during that operating period.

Mr. ANDERSON. What has been MARAD's success ratio to date in avoiding or mitigating the impact of default or bankruptcy through the use of various workout strategies?

Mr. DECARLI. I can't really answer that question on an overall basis and I really don't know what MARAD's current situation is.

Mr. ANDERSON. Would you want to do it for the record later?

Mr. DECARLI. Well, I can tell you based on our 1986 audit results what we found.

Mr. ANDERSON. Okay. That's fine.

Mr. DECARLI. At that point in time, we looked at 21 companies that had workouts, and the workouts we looked at were those during the 15-month period prior to October 31, 1985. When we looked at those 21 companies, at the time we issued our report, 11 of those companies had already defaulted. We made a prediction that, after looking at the financial status of the remaining 10 companies, that 8 of the 10 would probably default in the next two years.

In preparation for this hearing, we went back and took a look at what happened to those 10 companies and we found that 8 of the 10 actually did default, so of the 21 companies that we looked at, 19 or 90 percent ended up defaulting and MARAD ended up paying $614 of $790 million that it had guaranteed on those loans.

Mr. ANDERSON. To your knowledge, does MARAD have formal documented procedures governing the maintenance and disposition of foreclosed assets?

Mr. DECARLI. Our prior audit work, we have done a limited amount of audit work on those issues. Our audit primarily involved the storage question, the storage and insurance issues involving the vessels. At the time we did the audit, MARAD did not have formal written procedures on those issues.

Mr. ANDERSON. I am going to ask you the same question that I asked Mr. Mead, the one that Mr. Biaggi, I guess, received an answer on; and that is, what is the worst case scenario in terms of potential cumulative defaults under the title XI program from your point of view?

Mr. DECARLI. Well, we haven't looked at the program in quite a while. Realistically, we have $2.2 billion that we have already borrowed from the Treasury on defaults. We have another $400 million that we recently borrowed. MARAD has an additional $4.2 billion of loans on their books, and of that MARAD considers about $500 million to be high risk and about $1.5 billion to be medium risk. So, taking a worst case situation, if all the high and medium risks have problems, you are looking at about another half of the portfolio, another 50 percent. That is a worst case situation, I would think.

Mr. ANDERSON. Mrs. Bentley?

Mrs. **Bentley**. You touched on a couple of these questions I am going to ask, but I would just like the record to have a little more data on them. Is the real problem with the title XI program the international economic conditions facing the maritime industry or the management of the program by the Government?

Mr. **DeCarli**. I think it is probably more economics than the management of the program. Clearly, the condition of the petroleum industry, the condition of agriculture, had a very serious impact on the loans that MARAD had outstanding.

Mr. **Mead**. We would concur with that. There is an interesting perspective here. For many years this program operated quite successfully, without defaults. Then, almost abruptly, we had to shift gears, and we are now dealing with defaults. It is a major change in composition of the program and the operations of the program, and management has had to adjust to that. I believe that the current Administrator and Deputy Administrator have a commitment to doing just that.

Mrs. **Bentley**. Do you believe that the provision that this committee added to the fiscal year 1988 MARAD authorization bill, eliminating inland barges and offshore vessels from the program for 3 years, will significantly reduce exposure to default?

Mr. **DeCarli**. I don't have a view on that. I have not looked at that issue.

Mr. **Mead**. I am not sure that MARAD was inclined to extend additional guarantees to vessels in those classes to begin with.

Mrs. **Bentley**. In the 21 companies you were talking about, were any of those barge companies, do you know?

Mr. **DeCarli**. I don't have that information, but I can provide it for the record.

[Information not received at time of printing.]

Mrs. **Bentley**. OK. I would appreciate that.

Do you have any recommendations about the future. I mean, we all know we can rehash and rehash and rehash what happened. How do you think this program should be handled in the future? Do you think we should have a program in the future of title XI? Let me ask you that.

Mr. **DeCarli**. I don't see a problem with having a title XI program. I think we need to have something out there for the industry. I think we need to be very cautious in the kinds of loans that we are issuing, and take a good look at the economic conditions of the industry. Probably we need some better forecasting of where the industry is headed, before we issue those kinds of loans.

I think, clearly, the thing that got us in the most trouble was the downturn in the oil industry and agricultural products. If we had maybe better forecasting of those industries before we went into the loans, we might not have had as serious a problem as we ended up with.

So, looking at the financial condition of the applicant and the industry, the type of vessel that we are going to finance, I think that is probably the key to the future.

Mrs. **Bentley**. So, we should go looking into a much broader range than just the so-called shipping industry per se, but we have to look at everything that is affected by it or affects it?

Mr. **DeCarli**. Yes. We have to look at the economic conditions.

Mr. **Mead**. And probably, as a matter of national policy, think through, when we have another energy crisis, now that we have the advantage of 20-20 hindsight, do we want to concentrate that number of guarantees in an industry that looks good for the moment?

Mrs. **Bentley**. Have any of you looked into the so-called UNCTAD carriage of goods, which is the United Nations Convention on Trade and Development, whereby they would require for a trading partner, say we carry 40 percent and the trading partner would carry 40 and 20 percent would be given to the third-flag country? This would guarantee American ships certain cargoes. That is what I was really getting at. Our policy has been against it, I mean U.S. policy has been against it. The State Department doesn't believe in anything for the American merchant marine anyhow, but this would protect not the oil tankers per se, but it would protect the regular carriers, the liners.

Mr. **Mead**. No, we have not examined that.

Mrs. **Bentley**. You have never gotten into anything on policy concerning cargoes in that?

Mr. **DeCarli**. No, we haven't looked at it, either.

Mrs. **Bentley**. OK. Thank you, Mr. Chairman.

Mr. **Biaggi** [acting chairman]. Mr. Coble. You are going to vote? OK.

Well, I have some questions. I will stay here.

I really did listen to your testimony, and I have lived with this program for a long time; and I have seen it flourish, and I have seen the precipitous decline. We were a little suspect, members of this committee were suspect, as to the manner in which it was being managed and whether or not there was some favorable treatment.

At least, it is the way to go into a hearing, but listening to witness after witness, it was logical to conclude that everything that could go wrong went wrong at the same time. There might have been one or two instances where poor judgment was exercised, but we are all guilty of that at one time or another. And, barring a miracle of sudden reversal in the economics of the industry, title XI is going to be subjected to continued defaults until we reach relatively the bottom of the barrel, which is about $6 billion away from the $8 billion we had at the outset.

If title XI is to survive, clearly, what will be required is stricter measures in the eligibility area, in limiting the areas of those who would be eligible to apply. I have any number of questions, but the best that can be said about what is happening is, management in all areas will be chipping away at the edges, trying to shore up the fund, and I am sure you are doing that to the best of your ability. Given the element of bureaucracy, which invariably has a dilatory effect, I can only wish you well in doing what you are doing. The suggestions that have been made should be implemented as quickly as possible, but I have a foreboding sense of pessimism for the future of the balance of the $4.4 billion unless there is, by some circumstance beyond our contemplation at the moment, a reversal in the industry.

I have no questions. I said I had a number, but they are not going to help obtain the objective that we want. You know what the problem is. You know what you must be doing and you are doing it. I would say do it faster, so even though we may effect some savings, relatively speaking, nickels and dimes, but we are confronted with a terrible situation.

I can only thank you for your testimony. Good day, gentlemen.

Deputy Administrator Elaine Chao, Maritime Administration, accompanied by Richard Bowman, Associate Administrator for Maritime Aids, and Robert J. Patton, Jr., the Deputy Chief Counsel.

Good morning, Ms. Chao. I would like to compliment you on the work you have been doing since you took office. I am sure people in the Administration know what you have been doing, and I want you to know that even those of us on the Hill, in a seemingly remote position, are not without sources of information. We commend you for what you have been doing concerning the title XI program.

STATEMENT OF ELAINE CHAO, DEPUTY ADMINISTRATOR, MARITIME ADMINISTRATION, U.S. DEPARTMENT OF TRANSPORTATION, ACCOMPANIED BY RICHARD E. BOWMAN, ASSOCIATE ADMINISTRATOR FOR MARITIME AIDS; AND ROBERT J. PATTON, JR., DEPUTY CHIEF COUNSEL

Ms. Chao. Thank you, Mr. Chairman.

Mr. Chairman and members of the Subcommittee on Merchant Marine, my name is Elaine Chao, and I am the Deputy Maritime Administrator of the Department of Transportation. Again, it is a pleasure for me to appear this morning at your oversight hearing. With the permission of the Chair, I would like to submit my prepared statement for the record and paraphrase some of the major points. My testimony will include comments on the major accomplishments which have been made in the strengthening of the title XI program. I will also comment on H.R. 1037, a bill to assist the efficient and economic use of the existing vessels, including title XI defaulted vessels.

First, I will address the title XI guarantee program. The last time the Department appeared before your Subcommittee on Oversight was two years ago, on June 25, 1985. At that time, the title XI program was adversely affected by the worst maritime downturn in history. Approximately 20 percent of the title XI portfolio defaulted or was at significant risk. We are cautiously optimistic now that the risk portion of our current $4.3 billion portfolio has dropped significantly.

In the past year, we have initiated or are initiating a number of actions to improve our management of the existing portfolio. These actions include the following: reorganizing our staff to deal with bankruptcy and workout situations; establishing a special asset sales unit for the disposal of repossessed equipment; updating the agency's management information system to provide more timely and better management information on our outstanding portfolio and inventory of defaulted equipment; implementing a more coordinated and computerized covenant monitoring system; instituting a portfolio-wide risk categorization program; and also implementing an efficient custodial program for defaulted laid-up vessels to optimize the resale value and, of course, the return to the U.S. taxpayer.

In addition to these management improvements, the enactment of bankruptcy legislation last October has been a significant development. Two years ago, we informed the subcommittee of the inability of DOT to take timely foreclosure action. The Secretary did not have the ability to protect the Government's financial interest, because almost all of the defaulted title XI vessels were being operated by their owners under the protection of the bankruptcy court.

Those vessels were being operated in most cases with no capital cost to cover, because the shipowner had defaulted and the debt had been paid off. The continued operation without coverage of capital cost was causing significant injury to the remainder of the industry. The bankruptcy legislation amended section 362 so that, after 90 days, both DOT and the Department of Commerce would have the authority to foreclose.

There have been a number of encouraging aspects of this legislation which shouldn't go unnoticed. Carriers in financial trouble are now more inclined to attempt to find workout solutions with us than in the past. The legislation has also helped significantly in getting adequate protection payments for vessels operating in bankruptcy, as well as accelerating the pace of filing and development of reorganization plans.

However, we should also note that some of the bankruptcy courts which have considered this issue have enjoined us from foreclosing on those owners who have filed for protection under chapter 11, after the 90 days. The courts' rationale appears to be that the opportunity for a debtor to reorganize under chapter 11 outweighs the right of the Government to foreclose.

We believe that these bankruptcy court decisions continue to unduly favor the debtor at the expense of the taxpayer, and adversely affect the carefully drawn balance that Congress struck between the interests of maritime debtors and the Departments of Transportation and Commerce. We believe that this is not the intent of Congress, to enjoin the Government in the exercise of its powers under section 362; and, therefore, we are pursuing appeals of these decisions. Depending on the outcome of these appeals, we may need additional legislative language.

Mr. Chairman, if I may, I would like now to respond to the request for the Administration's views on the reports by the DOT Inspector General and also the recent GAO report concerning the title XI program. These reports covered a wide variety of aspects of our title XI program which I don't really need to outline here.

What is important to note is that these reports have been helpful in reinforcing the Administrator's and my efforts to identify and also implement improvements in the management of this program. The agency has already complied with the recommendations in the Inspector General's report, and has been or is complying with the GAO recommendations.

Finally, we have been asked to present our views on H.R. 1037. The bill would appear to have merit, as it would assist departments and agencies, including DOT, in disposing of vessels surplus to their requirements. This action should result in overall savings to the Federal Government.

As you know, the efficient disposal of title XI defaulted equipment has been a problem, and we deeply appreciate the interest of this subcommittee, and Congressman Lowry in particular, in proposing H.R. 1037. However, it now appears that such legislation may not be required. Title XI of the Merchant Marine Act of 1936 gives us special authority for disposing of defaulted title XI equipment.

The introduction of H.R. 1037 has served to further sensitize us in recognizing an area where additional coordination within the Government would be helpful, and we are currently working with OMB and other agencies to achieve this result administratively. We have strong reason to believe that this effort will be successful, so that this legislation would not be required; and, therefore, we respectfully request that further action on H.R. 1037 be deferred for at least 30 days, until we have had a reasonable period to determine whether our mutual goals can be accomplished administratively.

Mr. Chairman, that concludes my prepared statement, and I will be pleased to answer any questions that you or other Members may have. Thank you.

[The prepared statement of Ms. Chao can be found at the end of the hearing.]

Mr. ANDERSON. Thank you, Ms. Chao.

What is the current amount of outstanding guaranteed obligations under the title XI program?

Ms. CHAO. $4.4 billion.

Mr. ANDERSON. What?

Ms. CHAO. $4.4 billion.

Mr. ANDERSON. $4.4 billion. How much additional, unused title XI statutory guarantee authority does MARAD have?

Ms. CHAO. About $5.2 billion.

Mr. ANDERSON. $5.2 billion. And what is the current balance in the Federal Ship Financing Fund?

Ms. CHAO. It was about $60 million, as of October 1, 1987.

Mr. ANDERSON. What is the annual fund revenue from guarantee fees, earnings, and any other sources, other than Treasury borrowing?

Ms. CHAO. For fiscal year 1987, our fees were about $25 million. We also had $7 million in repayment of principal and interest, $1.8 million in charter payments, $3.4 million in adequate protection payments, about $57 million in fiscal year 1987 in sale of assets and about $10.6 million in miscellaneous receipts; a total of about $104.8 million.

Mr. ANDERSON. What is the current annual level of debt service payments to the Treasury?

Ms. CHAO. As of October 1, 1987, it was about $11.7 million at approximately 7.25 percent. That was our last payment.

Mr. ANDERSON. What additional Treasury borrowing do you anticipate will be required in the future because of further program defaults?

Ms. CHAO. Our budget projection for fiscal year 1988 was $350 million. That projection has been revised to $250 million.

Mr. ANDERSON. What is your current estimate of additional program defaults for fiscal year 1988?

Ms. CHAO. Currently, we are cautiously optimistic, and we believe that about $250 million would be a more updated number.

Mr. ANDERSON. Has the portion of the guaranteed loan portfolio characterized as moderate-to-significant risk remained constant over the last year?

Ms. CHAO. It has decreased.

Mr. ANDERSON. It has decreased?

Ms. CHAO. Yes.

Mr. ANDERSON. Is any Treasury borrowing used to make payments on previous borrowing?

Ms. CHAO. The borrowings are used to extinguish Treasury notes.

Mr. ANDERSON. What percentage of amounts paid out on guaranteed defaults do you typically recover through asset foreclosure and resale?

Ms. CHAO. It depends on the market segment, but they range from 5 percent to 45 percent. The average is about 35 percent, I would imagine.

Mr. ANDERSON. I have some more questions, but I think I will yield at this time to my colleague, Mr. Biaggi.

Mr. BIAGGI. Ms. Chao, you made reference to legislation that we enacted concerning bankruptcy and asset recovery, and that some of the bankruptcy courts are still taking a view contrary to congressional intent. I know you are in the process of appealing certain decisions and, hopefully, the result conforms with our intent. You also stated that the legislation has induced some of these companies to seek workout situations. What is MARAD's record to date in recovery of vessels pledged as security?

Ms. CHAO. We still have problems with certain assets, but I believe that we are now recovering more. I can give you the specific numbers if you like.

We have had approximately 2,000 pieces of defaulted equipment between fiscal year 1982 and fiscal year 1987; and, currently, MARAD does not have control or custody of about 87, but these 87 pieces of equipment represent approximately $460 million of the $2.1 billion in defaults or about 22 percent over the same time period.

Mr. BIAGGI. Well, that is an improvement. Are we eliminating tax-advantaged companies from the portfolio as a result of that legislation, or are they the people that are still fighting us?

Ms. CHAO. Our usual policy is to foreclose as soon as possible after default. Obviously, if companies defaulted and went into chapter 11, before the bankruptcy legislation, they have the protection of Chapter 11, and they continue to be a problem.

Mr. BIAGGI. Oh, I see, but which companies are they? Are they the genuine maritime people, or are they companies that are financially packaged in a sophisticated fashion in New York and Chicago and——

Ms. CHAO. It is hard to give a breakdown, but——

Mr. BIAGGI. I was just curious.

Ms. CHAO [continuing]. It includes both. It includes companies that have been put together for tax purposes. It also includes companies that are real operating companies.

Mr. Biaggi. What benefits to shipyards and operators do you expect from the rule liberalizing domestic content requirements for title XI financing?

Ms. Chao. We believe that the shipyards and the operators should benefit from this liberalization, because now shipyards will be able to solicit bids from a variety of sources and thus be more competitive in their pricing.

Mr. Biaggi. That's all, Mr. Chairman. Thank you very much.

Mr. Anderson. Thank you, Mr. Biaggi.

Ms. Chao, can you describe the demand for defaulted vessels in your inventory by type?

Ms. Chao. It again varies according to the market segment. We have had a good track record with tug supply boats and inland river barges. We have had more difficulty with some of our LNG's and other oceangoing, larger assets.

Mr. Anderson. Can you tell us what the total proceeds are to date from the sales of foreclosed vessels?

Ms. Chao. I believe in fiscal year 1986 it was $10 million and in fiscal year 1987 it was $57 million through sale of defaulted vessels.

Mr. Anderson. It was what?

Ms. Chao. $57 million.

Mr. Anderson. Now, your testimony recommends a 30-day delay before markup of H.R. 1037. Wouldn't it be better if we proceeded to mark up the bill concurrently with your attempts to secure the edition of an executive order directed toward the same result?

Ms. Chao. Current Government regulations do require other Government agencies to check within the Government to see whether there are surplus assets which could be useful in their particular acquisition. The title XI program is exempt from the Government procurement requirements. I think that for title XI assets to be considered by the rest of the Government agencies would be in line with current Government regulations and could be implemented expeditiously and without much delay.

Mr. Anderson. Should we modify H.R. 1037 to ensure that proceeds from interagency sale of vessels are deposited in the Federal Ship Financing Fund?

Ms. Chao. I think H.R. 1037 would require other Government agencies to consider MARAD equipment if it is at a competitive price. We clearly would sell the equipment at a competitive price and the funds, it would seem to me, would naturally go into the Ship Financing Fund as a sale of our asset.

Mr. Anderson. For the record, can you provide a complete chronology of the events relating to the default or foreclosure and disposition of certain tractor tug vessels by a West Coast operator, culminating in the foreign sale of those vessels?

Ms. Chao. Yes, and we are working on that for you.

Mr. Anderson. Would you, and for the record? That should be sufficient.

Ms. Chao. Yes.

[The information follows:]

Tractug Associates

o June 20, 1986	Foreclosure sale on CHANDON, CHALONE and MONTELENA.
o July 3, 1986	Sale confirmed title transferred to MARAD.
o July 28, 1986	MARAD approved advertising of three vessels with bid closing date of August 29, 1986.
o September 29, 1986	MARAD rejected three charter bids from July advertisement.
o August 8, 1986	Foreclosure sale on CONDON.
o August 13, 1986	Sale confirmed on CONDON.
o September 1986 - October 1986	MARAD worked with Panama Canal Commission regarding the possible purchase of one or two tractor tugs.
o March 3, 1987	Foreclosure sale on CAYMUS and MONTALI.
o March 30, 1987	Sale confirmed on CAYMUS and MONTALI.
o March 26, 1987	MARAD approved advertising of six tractor tugs with bid closing April 24, 1987.
o April 27, 1987	MSC solicitation for tractor tugs in Kings Bay, GA.
o May 20, 1987	Foreclosure sale under Texas UCC on Hull 118 and 119 at Cameron Shipbuilding.
o July 10, 1987	MARAD approved sale of four to six completed tractor tugs to Ton Kooren International Marine Services and/or the CONDON and CHALONE to Wilmington Transportation Company provided Ton Kooren does not purchase the CONDON and CHALONE.
o August 12, 1987	Sale closing on all six tractor tugs to Ton Kooren.
o August 3, 1987	MARAD approves sale of Hulls 118 and 119 to Bay Transportation Company.
o August 28, 1987	Sales closing on Hulls 118 and 119.

Chronology of Sale of Six Completed Tugs

o May 14, 1987	Received charter/purchase offer for all six tugs from Mustang Island Transportation Corporation (MITC). MITC informed that charter proposal was unacceptable.
o May 29, 1987	Received charter/purchase offer from Wilmington Transportation Company (WTC) for two tugs (CONDON & CHALONE). WTC informed charter proposal was unacceptable.
o June 1, 1987	Received purchase offer for four tugs (CONDON, CHALONE, MONTELENA and CHANDON) from George Gounares (Broker) for Ton Kooren. Broker was informed price too low at $600,000 each.
o June 17, 1987	Met with WTC regarding offer to purchase two tugs. WTC proposed to purchase two tugs for $1.7 million or $900,000 for one tug. WTC was given no assurance that offer would be approved.

o June 22, 1987	Broker submitted an offer to purchase 4 to 6 tugs for $750,000 each and reflag tugs. Broker was advised price still to low.
o June 24, 1987	Met with Broker to discuss previous proposal. Broker offered to increase bid to $775,000 per tug subject to Ton Kooren approval.
o June 25, 1987	Received offer to purchase 4 to 6 tugs for $775,000 each.
o June 30, 1987	Recommended approval of sale to Ton Kooren
o July 10, 1987	Sale to Ton Kooren approved.

Chronology of sale of two incompleted hulls, Hull 118 and 119

o July 2, 1987	Received proposal from George Gounares offering $1,500 for a 45 day option to purchase the hulls. Proposal not accepted.
o July 20, 1987	Received two proposals from Arbor Marine, Inc., regarding purchase of both hulls. Offer 1 for $350,000 on "as is, where is" basis. Offer 2 for $400,000 after inspection with right to withdraw bid.
o July 21, 1987	Received purchase offers from Belcher Oil Company, Bender Ship Repair and Bay Transportation Corp. The Belcher and Bay Transportation bids were subject to many conditions. The purchase prices were as follows:

BELCHER	BENDER	BAY TRANSPORTATION
$505,000	$300,000	$500,000

o July 22, 1987	Sent letter to Belcher and Bay Transportation asking for best and final offers by close of business July 24, 1987. Subsequently informed Gounares and Arbor of right to revise bids.
o July 24, 1987	Received revised bids from Belcher of $551,000 and Bay Transportation of $655,000. Also, received revised bids from George Gounares and Arbor Marine of $600,000.
o August 3, 1987	Approved sale of hulls to Bay Transportation.
o August 6, 1987	Rejection letters sent to unsuccessful bidders.
o August 6, 10 & 11, 1987	Received protest letters from Coastal States Management Corporation on behalf of Belcher.

(Received from the Maritime Administration)

CHRONOLOGICAL LISTING OF ATTEMPTED SALE OF FAUSTUGS TO PANAMA CANAL COMMISSION

May 1, 1986	Panama Canal Commission (PCC) issued Solicitation P-86-23 requesting priced technical proposals for one tractor tugboat with an option for a second boat. Closing date given as July 18, 1986.
July 21, 1986	TWX from MARAD to PCC offering several tugs in response to solicitation including FAUST tractor tugs.
October 3, 1986	PCC (Rhode) letter to House Panama Canal Subcommittee (HPCS)(Lowry) stating they had inspected seven MARAD tugs, found all unsuitable, and gave their original objections to FAUSTUGS.
October 6, 1986	House Merchant Marine Committee letters to PCC (Gianelli) and (McAuliffe) requesting PCC delay awarding tug contracts until they thoroughly survey the tractor tugs available from MARAD.
October 20, 1986	MARAD (Dye) letter to HPCS (Marshall) stating that the FAUSTUGS are suitable for PCC use with minor modification. Answered PCC October 3 objections with proposed fixes.
October 24, 1986	PCC (Gianelli) letter to HPCS (Lowry) explaining that FAUSTUGS and other MARAD-owned tugs could not meet their requirements.
October 31, 1986	Meeting at MARAD with PCC (Rhode).
	PCC (Rhode) letter to HPCS (Lowry) proposing that PCC award contract for first tug, invite MARAD to Panama Canal, discuss modifications to FAUSTUGS.
November 18-21, 1986	Visit to Panama Canal to see tug operation and ship transits — MARAD (Wakeman, Hammer, Dye) and HPCS (Marshall).
November 20, 1986	MARAD meeting with PCC to discuss requirements of Solicitation P-86-23.
December 8-12, 1986	Visit to Seattle, Washington and Benica, California to survey ZP CHALONE and ZP CONDON — MARAD (Hammer, Fuller, Wetzel, Fleisher, and Schubert) and PCC (Witt, Watkins, McBride).
December 17, 1986	Foss letter to MARAD providing costs for activation and trial of ZP CHALONE.
December 18, 1986	MARAD started design of modifications to meet PCC requirements.
December 23, 1986	PCC (DeLeonardis) letter to MARAD (Fuller) detailing H-bitts and winch drum and also providing plans.
December 24, 1986	MARAD (Gaughan) to PCC (McAuliffe) inviting PCC to operational test of tug, requesting PCC testing requirements and plans and specs of HOUMA tugs.
January 16, 1987	PCC (McAuliffe) letter to MARAD (Gaughan) stating that the FAUSTUGS were unsuitable for their use.
January 29, 1987	MAR-721 surveyed ZP CHALONE and discussed reactivation and repairs with Foss representatives.
January 30, 1987	Cost estimate to reactivate and modify ZP CHALONE and ZP CONDON completed.
February 5, 1987	Inspected ZP CHALONE in Foss drydock. Repairs to kort nozzles and propellers and bottom painting complete.
March 2, 1987	MARAD (Gaughan) letter to PCC (McAuliffe) giving status report on design of tug modifications and sea trial.
March 24, 1987	PCC (McAuliffe) letter to MARAD (Gaughan) again turning down tugs and refusing to witness operational tests.
April 21, 1987	Phone call to PCC, Washington to invite PCC representative on sea trial; PCC (Rhode) strongly declined.
April 28, 1987	Successful sea trial of ZP CHALONE.
____________	FAUSTUG tractor tugs sold to other parties.

Mr. ANDERSON. In your summary of this transaction, can you comment on the extent which domestic market conditions play in the decision to sell them foreign? If a market niche were demonstrated to exist without adversely affecting domestic operators, would those vessels be permitted to reenter the United States registry?

Ms. CHAO. Certainly, MARAD is always concerned about its particular impact on the particular market segment from which the defaulted equipment came. In terms of your second question, certainly if a sale to a market niche were demonstrated to not adversely affect the domestic carriers, that would be considered our decision.

In the summary of this transaction, I would also say that the sale of the tractor tug vessels again were based on a case of pure economics, as are most of our sales.

Mr. ANDERSON. What are your procedures for management and disposition of assets acquired through foreclosure? Are they formalized and documented, and have they been promulgated in the Federal Register?

Ms. CHAO. Our procedures are not formalized and documented, although we do have a very clear policy internally as to management and disposition of the assets, and they have not been promulgated in the Federal Register. Basically, as soon as an owner has defaulted on a particular asset, it is our policy to foreclose as quickly as possible, depending on whether the defaulted owner voluntarily or involuntarily returns the asset. If he voluntarily returns the asset, we can work with the owner to take possession of the asset, but we still need to foreclose. Clearly, if the owner defaults and then goes into bankruptcy, we are involved in a very lengthy litigation process to try to foreclose and regain recovery of the asset.

Mr. ANDERSON. To what extent does pressure from domestic operators not to dump foreclosed tonnage back on the market play in your decision on the disposition of assets in your inventory?

Ms. CHAO. As I mentioned, I think we in MARAD are always concerned about what potential impact our actions would have on a particular market segment; so, in our analysis of any of our potential actions, we would always analyze what the market impact would be in any case.

Mr. ANDERSON. Well, have these considerations affected the sales price and rate of recovery in relation to the amounts paid out in default on guaranteed obligations?

Ms. CHAO. Well, I think in terms of the tugs, supply boats, and in terms of drill rigs and inland barges, we have required certain restrictions, certain placement or certain scrapping of vessels, and that has, I think, possibly affected minimally the price and also possibly the recovery; but, again, it is for the concern about the market from which they came and for the other operators operating in those market segments.

Mr. ANDERSON. Now, do you have the authority to sell vessels foreign, including vessels built with construction-differential subsidy such as the LNG vessels?

Ms. CHAO. Those LNG vessels, because they received CDS, cannot be sold to a foreign company, a foreign owner, for the duration of their statutory economic life. That has to be changed legislatively.

Mr. **Anderson**. What was the basis for your disposition decisions concerning the bankrupt United States Lines Econ ships?

Ms. **Chao**. MARAD does not own the Econ ships. Our only involvement in the disposition of those ships is in the determination of whether a section 9 approval should be granted to allow these vessels to be sold foreign. The Administrator felt very strongly that if these vessels were reflagged foreign the potential adverse competitive impact on our own American-flag carriers was great enough so that the section 9 approval was not granted. More importantly, the Navy has deemed them to be assets critical to national security and, therefore, we would not grant a section 9 (foreign ownership) approval.

Mr. **Anderson**. Well, thank you very much, Ms. Chao and Mr. Bowman and Mr. Patton, for your presentation, an excellent presentation.

Ms. **Chao**. Thank you.

Mr. **Anderson**. Our final witness today is Mr. W. Patrick Morris, vice president and general counsel, the Shipbuilders Council of America.

Mr. Morris, we do have your prepared statement. It will appear in the record. You can read, extemporize, any way you wish. The floor is yours.

STATEMENT OF W. PATRICK MORRIS, VICE PRESIDENT AND GENERAL COUNSEL, THE SHIPBUILDERS COUNCIL OF AMERICA

Mr. **Morris**. Thank you, Mr. Chairman.

I am W. Patrick Morris, vice president and general counsel of the Shipbuilders Council of America. The Council is the national trade organization representing principal domestic shipbuilders, ship repairers, and vendors to those industries. We appreciate the opportunity to express our views on the Federal Ship Mortgage Guarantee Program, also known as title XI.

The Council doesn't have a position on Mr. Lowry's bill, H.R. 1037. Our reason basically is that we haven't really had an opportunity to focus on it. On the other hand, based on my reading of it, I really question the need for it for the reasons expressed by Administrator Chao.

The value of the United States Government's guarantee on the credit rating of the owner of a vessel will depend, obviously, on the size and the economic strength of the individual applicant. Obviously, large companies with triple A credit ratings do not utilize the title XI program because they can obtain competitive interest rates without the guarantee. However, smaller companies who are poor credit risks can reduce their interest costs significantly.

Privately-owned U.S.-flag shipping companies are, by and large, not viewed as a high quality risk for debt financing by the investment community for a number of reasons, including their volatile earning patterns, high level of debt, and low return on capitalization. Thus, the availability of the title XI program has been very important to U.S.-flag operators because it allows them to modernize their fleets. Moreover, it has benefitted domestic shipyards because all the work on the vessels must be performed in U.S. shipyards.

My prepared statement contains a chart which puts forth the type of vessels, their actual cost, their numbers, and the mortgage amount. The program really began in 1972 and, for all practical purposes hasn't functioned since 1986. In basically 14 years, roughly $15 billion of vessels have been assisted in their financing; so, in this regard you must admit that the program has, in fact, been a success, if you are trying to modernize your fleet and also stimulate construction in U.S. shipyards.

Also, GAO's statements indicate that essentially what caused the problem with the program in the early and mid-eighties, was the turn-down in the oil market and likewise a decline in agricultural exports. The management decisions at the agency, in my judgment, had little or nothing to do with those events. Obviously, if you seek the views of economic forecasters, you can get a different view from each of those different forecasters.

It is an understatement to say that the title XI program has not been very popular with this Administration. Rigid limitations were sought in the amount of loan commitments which the agency could enter into in a given fiscal year. Conceivably, such limitations could have been rationally defended because of the rapidly changing market conditions. However, that figure ultimately reached zero in fiscal year 1986.

Last October, the program reached its nadir. On that date, President Reagan pocket vetoed H.R. 4175, the Maritime Authorization Act for fiscal year 1987, because the measure did not repeal the title XI program. It is our understanding that the Office of Management and Budget was the driving force behind the veto. Fortunately, the Congress in general and this committee in particular has steadfastly refused to accede to the desires of the Administration with respect to the program. You have been most supportive of the program, and the Council applauds your action in this regard.

The title XI program remains as probably the most important maritime program designed to assist operators to finance the construction in domestic shipyards of complex, efficient merchant ships. At the present time, the Maritime Administration has ample unused guarantee authority at its disposal to carry out the program. As a prior witness indicated, they have roughly in excess of $5 billion of unobligated authority.

The real issue is whether the agency possesses the willpower to implement a program which the Congress supports and the maritime industry desperately needs. A number of applications which would appear to have merit are currently pending before the agency. For example, the American Ship Building Company recently filed an amended application for a title XI guarantee to assist in the financing of the construction of two 1,200-passenger cruise ships for the rapidly expanding inter-island Hawaii trade.

This project, which has a total value of $310 million, represents the first viable endeavor to build in the United States large, modern, efficient passenger ships in three decades. Approval of the project by the agency would greatly augment the economics of the project. The project represents over 2,000 shipyard jobs and will provide hundreds of seagoing billets over the life of the two ships.

The Council urges this committee to continue to back the title XI program as a necessary tool to aid operators and shipyards in the highly competitive shipping world.

This concludes my prepared remarks.

[The prepared statement of Mr. Morris can be found at the end of the hearing.]

Mr. ANDERSON. Mr. Morris, do you agree with the conclusion of the Inspector General's report that MARAD is partially responsible for the unprecedented number of title XI defaults by its redirection of the program away from seagoing vessels toward the construction of barges and oil service equipment, without consideration of the likely market effects of overbuilding?

Mr. MORRIS. Well, my answer to that would be yes and no, in that in many respects you have to be put in the position of the Maritime Administrator when he made those decisions. He was looking at a very healthy oil industry at that time; and, basically, he was trying to diversify his portfolio when he, in fact, was making those decisions.

As I said earlier, the fact that all of a sudden the economic forecast totally fell apart in a rapid area, I don't think you can really finger him too much on that score. On the other hand, whether or not the focus of the program should have always been on vessels rather than on energy projects, I would say it should have been and should be on the former, and I applaud the action by Congressman Davis in the current authorization bill, which would redirect the program back to seagoing vessels.

Mr. ANDERSON. Well, did the shipbuilding industry support this speculative wave of overbuilding?

Mr. MORRIS. Some of our members surely did.

Mr. ANDERSON. Some of your members surely would, you say?

Mr. MORRIS. Yes, they did.

Mr. ANDERSON. Well, now, do you support the committee's action earlier this year to redirect the title XI program back to its original objective of financing the domestic construction of seagoing vessels?

Mr. MORRIS. I believe that is the proper way to go under the circumstances.

Mr. ANDERSON. What types of seagoing vessels are candidates for domestic construction using title XI financing in the future?

Mr. MORRIS. Now you have passenger ships. There are a number of applications. I believe there are a half a dozen of them pending at the agency. Other legislation currently going through the Congress—for instance, the fish processing legislation and the bill that passed the House dealing with the carriage of valueless merchandise—identify markets where the title XI program could apply and assist the people who want to get involved in those trades.

Mr. ANDERSON. If title XI financing were not available to these operators, would this further reduce the likelihood of any commercial ship construction in United States shipyards in the future?

Mr. MORRIS. I definitely think so, yes.

Mr. ANDERSON. To your knowledge, are there any pending applications for new title XI loan guarantees currently under MARAD review?

Mr. MORRIS. I know there are some down there. Also, as I mentioned in my statement, the American Ship Building Company has recently filed an amended application. They have expended money on it. I would hope that the agency would either say yes or no to that project, and that then would give the Congress an opportunity to really look at the program and give some direction to the Executive Branch in this area.

Mr. ANDERSON. Now, have any applications been refused to date because of agency inability to exercise its statutory obligation authority?

Mr. MORRIS. Offhand I don't know. Since no application for a new project has, in fact, been approved since fiscal year 1986, I would think the answer is that they are presently not approving anything. They have done, on the other hand, a number of restructurings of current financing.

Mr. ANDERSON. Do you consider maintaining the title XI financing program important to maintaining commercial shipbuilding in this country?

Mr. MORRIS. Yes, I do, sir.

Mr. ANDERSON. And could the availability of title XI ship financing guarantees complement the commercial construction of militarily useful vessels under a Government-sponsored build-and-charter program?

Mr. MORRIS. Yes, it could. In fact, it would be very, very helpful.

Mr. ANDERSON. Would the availability of capital construction fund financing likewise complement a build-and-charter program?

Mr. MORRIS. It depends if the operator is a seasoned operator who had sufficient monies in his capital construction fund. A fellow who got involved, initially he wouldn't have any monies in his fund so it wouldn't help him at all. On the other hand, as I said, if you had an established operator who, in turn, had been making deposits into his CCF, obviously it would be a great aid to getting a build-and-charter program off the ground.

Mr. ANDERSON. Well, thank you, Mr. Morris, for an excellent presentation.

I believe that concludes this hearing, so at this time we can go to lunch. The meeting is adjourned.

[Whereupon, at 11:45 a.m., the subcommittee adjourned subject to the call of the Chair.]

[The following was received for the record:]

I

100TH CONGRESS
1ST SESSION

H. R. 1037

To require that departments and agencies of the United States obtain suitable vessels owned by and available from the Maritime Administration or any other department or agency before acquisition or construction of any new noncombatant vessel.

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 5, 1987

Mr. LOWRY of Washington (for himself, Mr. BIAGGI, Mr. DAVIS of Michigan, and Mr. LENT) introduced the following bill; which was referred to the Committee on Merchant Marine and Fisheries

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A BILL

To require that departments and agencies of the United States obtain suitable vessels owned by and available from the Maritime Administration or any other department or agency before acquisition or construction of any new noncombatant vessel.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That no department or agency of the United States shall acquire, construct, or arrange for the construction of a noncombatant vessel until the procuring entity certifies to the General Accounting Office that no vessel capable of meeting the performance requirements of the intended mission is obtainable from the Maritime Administration or any other department or agency of the United States.

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DUNCAN C. SMITH III

October 14, 1987

TO: MEMBERS, SUBCOMMITTEE ON MERCHANT MARINE

FROM: Majority and Minority Staff

SUBJECT: Oversight Hearing on the Federal Ship Financing Program Under Title XI of the Merchant Marine Act, 1936.

At 10:00 a.m. on Thursday, October 15, 1987, the Subcommittee will convene the third in a series of oversight hearings on the Federal Ship Financing Program under Title XI of the Merchant Marine Act, 1936 administered by the Maritime Administration (MARAD) in the U.S. Department of Transportation. The hearing will also consider H.R. 1037, a bill to require that departments and agencies of the United States obtain suitable vessels owned by and available from the Maritime Administration or any other department or agency before acquisition or construction of any new noncombatant vessel.

Witnesses have been invited to testify from the Maritime Administration, General Accounting Office, Office of the Inspector General of the Department of Transportation, and the Shipbuilders Council of America.

BACKGROUND

The Title XI Federal Ship Financing Program originated in a 1938 amendment to the Merchant Marine Act, 1936. Modeled after Government-sponsored mortgage insurance programs in the housing sector, the program was underutilized and ineffective in achieving its intended purpose in promoting private investment in the domestic maritime industry. The program became more effective after being restructured in the Federal Ship Financing Act of 1972 (Public Law 92-507) in the form of a full faith and credit guarantee by the Federal Government of commercial debt instruments used to finance domestic ship construction. Under this arrangement, the borrower executes a preferred ship mortgage with MARAD as mortgagee; in effect pledging the vessel itself as security for the loan guarantee. MARAD may require additional collateral as security at its discretion. Since the program's inception, MARAD has guaranteed financing for the construction of approximately 7,000 vessels with an aggregate value of $14 billion at time of construction.

Under the Omnibus Reconciliation Act of 1981 (Public Law 97-35), MARAD has statutory authority to guarantee $12 billion in outstanding obligations, $9.5 billion of which may be for vessels. Currently, title XI constitutes the only fixed-rate, long-term financing available for domestic ship construction.

The Federal Ship Financing Fund is a public enterprise revolving fund established to underwrite the Title XI Program. Fund revenue is generated from investigation fees, annual guarantee fees, and investment income. As recently as 1983, the fund had an accumulated balance of approximately $300 million. Since then, an unprecedented number of defaults on guaranteed obligations, now exceeding $2 billion, have exhausted the revolving fund and required MARAD to exercise its direct borrowing authority from the U.S. Treasury in order to pay bondholders outstanding principal and unpaid interest on defaulted obligations. Supplemental appropriations have been required to enable MARAD to reimburse the Treasury as other revenue to the fund is insufficient to meet the required repayment schedule.

In previous hearings on June 25 and October 3, 1985, the Subcommittee investigated the origins and magnitude of the current wave of defaults. With the assistance of the General Accounting Office, supplemented by the independent analysis of the Office of the Inspector General of the Department of Transportation, the Subcommittee traced the primary causes of program defaults to a combination of factors. These included: first, severely depressed economic conditions in the energy and agricultural sectors in which a sizable proportion of loan guarantees was made as a result of program expansion during the 1970's; second, uniformly liberal guarantee policies compounded by inadequate evaluation and approval procedures without adequate consideration of the negative impact of individual vessel guarantees on industry overcapacity; and third, MARAD mismanagement manifested in guarantee approval despite an internal agency finding of economic unsoundness and the expenditure of fund revenues for purposes of questionable legality.

Moreover, GAO and the Inspector General found that MARAD frequently aggravated the liquidity problems of the revolving fund by making advances to debtors in the form of direct loans to make principal and interest payments, thereby increasing the Government's total financial exposure and the magnitude of defaults. Auditors found that MARAD's workout success ratio was extremely low with most debtors benefitting from MARAD's forebearance policies, while eventually defaulting on guaranteed obligations anyway.

In response to the financial difficulties encountered in the Title XI Program to date, the Subcommittee has taken several legislative actions. The first was to reaffirm the primacy of the authorization ceiling (most recently amended in 1981) as the sole limitation on new loan guarantees by MARAD. This was accomplished in section 425 of the Surface Transportation Assistance Act of 1982 (Public Law 97-424).

The next such action was to impose stricter criteria on MARAD in granting Title XI guarantees, particularly with regard to barges, offshore supply vessels, and oil drilling equipment. Another change provided greater flexibility in the event of debtor default by permitting MARAD to intervene and continue to make principal and interest payments in lieu of foreclosing on future guarantees. These amendments were enacted in Public Law 98-595.

It became apparent during the hearings that MARAD was encountering difficulties in foreclosing on the underlying security of defaulted obligations because debtors were filing for protection under the bankruptcy reorganization laws. Under Chapter 11 of the Bankruptcy Code, the debtor-in-possession is granted an automatic stay of pending foreclosure proceedings in order to permit the debtor to reorganize under a court-approved plan. Continued possession and operation of vessels owned by the debtor are normally considered an intrinsic element of the reorganization effort. In fact, debtors were continuing to operate vessels without paying either debt service or equivalent payments to MARAD for the continued use of the vessels, thereby gaining a competitive advantage over solvent operators. This contributed to a downward spiral in freight rates and, eventually, to additional defaults by other operators.

The Subcommittee crafted amendments to the Ship Mortgage Act, 1920 to permit MARAD to foreclose under admiralty procedures on the underlying security notwithstanding the existence of a bankruptcy petition. That authority was enacted as part of the Omnibus Reconciliation Act of 1986 (Public Law 99-509).

During the consideration of the FY 1988 authorization bill for MARAD, the Committee developed an amendment to Title XI designed to minimize further defaults under the load guarantee program. The provision, added to H.R. 953, would exclude for three years all vessels used for Outer Continental Shelf development activities as well as any vessel (other than a passenger vessel) used in inland waterways. The bill is awaiting Senate action.

DISCUSSION AND ISSUES FOR CONSIDERATION

Two years have now elapsed since the last Subcommittee oversight hearing on the Title XI Program. Much has changed since that time. Recent trends indicate the worst may be behind us as the volume of defaults appears to be on the decline. However, the portion of the portfolio of outstanding guaranteed obligations -- with greater than moderate risk of default -- remains constant (20 percent), giving some cause for concern should economic conditions not improve in the agricultural and energy sectors of the maritime industry.

Beginning with the Prudential Lines bankruptcy, MARAD has successfully employed its limited statutory exemption from the bankruptcy stay. Perhaps more importantly the agency can exercise significantly greater leverage in negotiations with debtors prior to default or petition in bankruptcy. There are several pending applications for new Title XI guarantees. Internal administrative reforms recommended by GAO and the Inspector General have been undertaken that should provide a greater degree of management knowledge of the financial status of individual companies and control over the entire loan guarantee portfolio. MARAD is routinely disposing of vessels acquired through voluntary transfer or forfeiture, thereby generating new revenue to replenish the depleted reserve fund. In short, there is basis for optimism the Title XI Program can be rejuvenated as one of the few remaining pillars of maritime promotional policy with whatever additional administrative or legislative reforms are identified as a result of the hearing, the recommendations of oversight agencies, or the Subcommittee's own investigations.

The recent GAO report, prepared at Subcommittee request, provides answers to basic questions such as: the status and trends in the guaranteed loan portfolio; prospects for restoration of liquidity to the reserve fund; adequacy of internal agency data collection methods and management information systems in program evaluation; accuracy and reliability of external agency reporting data; and overall evaluation of agency risk assessment practices

H.R. 1037

As the focus of program activity begins to shift from defaults on guaranteed obligations to seizure, forfeiture, and the disposition of foreclosed assets, several new issues have arisen. One is whether Government agencies should be required to consider suitability of vessels from the MARAD inventory before proceeding with outside procurement. To this end, H.R 1037 was introduced by Mr. Lowry, Mr. Biaggi, Mr. Davis, and Mr. Lent. The need for the legislation was brought to light by the Subcommittee on Panama Canal and Outer Continental Shelf in its oversight of the Panama Canal Commission's procurement of new tractor tugs despite the availability of similar vessels in MARAD's inventory. This experience led the authors of the legislation to conclude that a need exists for a formal requirement of Federal agencies to certify to the Comptroller General or similar third-party arbiter that an agency has adequately considered acquiring a suitable vessel from MARAD before proceeding with outside procurement. The hearing will provide an opportunity to receive comments from MARAD and GAO on this proposal.

A related appropriate area of oversight inquiry concerns MARAD's policies with respect to the disposition of those vessels. This includes the adequacy of formal procedures to ensure proper notice and opportunity to bid on the part of all interested parties to ensure the highest possible return to the Treasury through the sale of assets. This objective in turn must be weighed against the competitive impact of market reentry of additional capacity with a lower capital cost structure into an industry already suffering from chronic overcapacity. This could threaten a repetition of the defaults that occurred before the enactment of the bankruptcy reform legislation. Many of the assets obtained by MARAD such as the aforementioned tractor tugs and other equipment, have military and commercial utility. Consideration should be given to whether they should be retained in the U.S.-flag inventory prior to being sold foreign.

The Department of Transportation Inspector General report also opens up the corollary issue of the offsetting costs of maintaining vessels in inventory pending disposition, including layup and maintenance expenses and insurance. The hearing should clarify current MARAD policies on this issue as well.

SUMMARY

The hearing should serve the dual purpose of concluding a comprehensive oversight of the entire administration of the Title XI Program, while providing an opportunity to evaluate the incremental reforms adopted to date. It should provide the opportunity for the Subcommittee to reaffirm its support for this vital program of ship financing assistance, as well as set the stage for consideration of further reform.

DISTRI: Member, Committee on Merchant Marine and Fisheries

STATEMENT OF KENNETH M. MEAD, ASSOCIATE DIRECTOR, RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION, UNITED STATES GENERAL ACCOUNTING OFFICE -- OCTOBER 15, 1987

Mr. Chairman and Members of the Subcommittee:

We appreciate this opportunity to testify on our recent report on the Maritime Administration's (Marad) Federal Ship Financing Program.[1] We performed our review at the request of this Subcommittee, and focused our work on (1) the program's financial condition, (2) certain data used to manage the program, and (3) Marad's reporting on the program's condition.

As the Subcommittee is aware, the program is experiencing serious financial difficulties. This is due in large measure to economic conditions in the energy- and agriculture-related segments of the maritime industry. By the end of fiscal year 1985, the program was no longer self-supporting[2], and this condition worsened in fiscal year 1986 when default payments exceeded $1.2 billion, the highest level in the program's 15-year history of guaranteeing loans. Default payments in fiscal year 1987 have dropped dramatically from a year ago, but program revenues continue to be substantially less than those necessary to cover defaults.

We also identified several problems related to the completeness and accuracy of Marad's program, financial, and budget data. The Department of Transportation and Marad have since taken or plan to take action to improve program data and reporting. When these improvements are in place, the Congress and other decision makers will have more useful and credible data on which to base key program decisions.

BACKGROUND

The Federal Ship Financing Program (commonly called the title XI program) was established by title XI of the Merchant Marine Act of 1936 primarily to encourage the construction of vessels in the United States. The act was amended in 1972 to, among other things, attract more private capital for vessel construction. Under the 1972 amendments, guarantees backed by the United States government are issued to U.S. citizen shipowners for the construction of a vessel or vessels. Guarantees mature in up to 25 years and the vessels usually form the security for the government's guarantee of the loans. The loans themselves are provided by private sector entities, such as banks. By law, the total amount in outstanding loan guarantees for vessels cannot exceed $9.5 billion at any given time.

The Federal Ship Financing Fund underwrites the program. The Fund receives income primarily from (1) fees paid by shipowners whose loans are guaranteed (these are determined by Marad in accordance with statutory limits), (2) interest on investments in United States Treasury securities, (3) the repayment of loans, and (4) proceeds from the sale of vessels acquired by Marad after it makes default payments to the private sector lender.

In the event a shipowner defaults, the U.S. government pays in full the unpaid principal and accrued interest of the guaranteed loan. Program expenses, including those to pay loan defaults and maintain vessels acquired through default, are paid from the Federal Ship Financing Fund. If the Fund's resources are not sufficient to cover these costs, Marad is authorized to borrow the money from the Treasury. The Fund is required to repay this money, with interest.

FINANCIAL CONDITION

The program's outstanding loan guarantees and commitments (loan portfolio) were less than $2 billion at the end of fiscal year 1973. They rose to a peak of more than $8 billion in fiscal year 1982 and declined to about $4.4 billion as of August 31, 1987. The expansion in the 1970s and troubles in the 1980s were due largely to the shifting fortunes of two industries--energy and agriculture.

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[1] Maritime Administration: Efforts to Improve Data on the Federal Ship Financing Program (GAO/RCED-87-58, August 28, 1987).

[2] As used here, self-supporting refers to the ability of the Federal Ship Financing Fund during the fiscal year to draw upon the Fund's balance and/or to generate revenues in amounts sufficient to pay all expenses, including default payments and Treasury borrowings, without congressional appropriations.

Increases in oil prices in the 1970s led to a national effort to decrease U.S. dependence on imported energy sources. As part of this effort, Marad extended loan guarantees for energy-related vessels, including domestic tankers and drill rigs. During the same period, a significant increase in agricultural exports led to requests for loan guarantees to construct inland tugs and barges. However, a sharp decline in oil prices in the 1980s reduced the demand for drill rigs and other energy-related vessels. Similarly, agricultural exports were not sustained at expected levels. Lower demand for vessels in both markets resulted in lower freight prices, reduced economic viability, and increased defaults.

Buffeted by these external forces, the program's financial condition has changed dramatically in the last few years. This change was due to a surge of defaults during fiscal years 1985 through 1987. During the 12 years from the loan guarantee program's inception in 1972 through fiscal year 1984, cumulative defaults were about $341 million. During fiscal years 1985 through 1987, defaults were about $1.9 billion. Thus, about 86 percent of the defaults in the program's 15-year history of guaranteeing loans were recorded in the past 3 years. (See att. I.)

Although companies with vessels operating in all segments of the maritime industry suffered some defaults from fiscal year 1985 through fiscal year 1987, the companies in the energy and agricultural segments accounted for a large share of the default payments that Marad made. For example, according to data obtained from Marad, loans for drill rigs and drill supply vessels accounted for about 42 percent of the total, those for liquefied natural gas vessels for about 19 percent, and others for agriculture-related vessels for at least 7 percent. In all, loan guarantees for these types of vessels accounted for about 68 percent of the total.

These defaults have had an effect on both the size and composition of the title XI portfolio. During the period September 1983 through August 1987, the total value of the portfolio declined from about $7.8 billion to about $4.4 billion. Energy-related segments were hit particularly hard. In another example, loan guarantees outstanding for drill rig vessels declined from nearly $1 billion to $228 million and guarantees for drill supply vessels declined from $362 million to $74 million.[3] The remaining figures in the attachment support these examples. Moreover, commitments to guarantee new loans each year steadily declined between fiscal years 1980 and 1985. A slight increase occurred in fiscal year 1986, but Marad did not commit itself to issue any new loan guarantees in fiscal year 1987. Attachments II and III present segment-by-segment detail on the portfolio's value and composition for fiscal years 1983-87.

The increase in defaults also has had repercussions for the program's operating budget. Fiscal year 1984 was the last year the Fund's revenues exceeded expenses--by about $27 million. Expenses exceeded revenues by about $250 million in fiscal year 1985, and about $755 million in fiscal year 1986.

These shortfalls used up the surplus that the Fund had accumulated in previous years. Marad, therefore, borrowed almost $1.4 billion from the Treasury by the end of fiscal year 1986 to cover these shortfalls. Since the Fund was not in a position to pay this money back, the Department of Transportation requested and the Congress later approved a supplemental appropriation of almost $1.4 billion to cover the shortfalls.

Another shortfall occurred in fiscal year 1987. Through August 1987, Marad had received revenues of about $95 million, but borrowed over $400 million from the Treasury to cover default payments and other expenses. Although default payments have dropped significantly from a year ago, Fund revenues will not be sufficient to repay these Treasury borrowings. Marad is seeking a fiscal year 1988 supplemental appropriation to repay this debt.

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[3] On June 2, 1987, the House of Representatives passed H.R. 953, which provides, among other things, that through the end of fiscal year 1989, loan guarantees will not be available for drill ships, supply boats, or other vessels designed or intended primarily for offshore oil or gas exploration and development.

FINANCIAL REPORTING AND PROGRAM MANAGEMENT INFORMATION

In addition to the title XI program's financial difficulties, several problems exist with financial reporting and program management data. These include inconsistencies in the value of outstanding loan guarantees and commitments and in reports on the Federal Ship Financing Fund's financial condition, and incomplete data on the extent of the portfolio at risk of default.

Financial reporting

In fiscal year 1985, Marad reported inconsistent data in its reports and other documents--one of which was sent to the Congress. These reports sometimes contained significant disparities in the number of loan guarantees and value of Marad's portfolio. Although these data are basic to program management and oversight, the discrepancies in the reports and other documents differed by up to $400 million. Marad has taken corrective action in this area and is now reporting consistent figures.

Marad also recorded a liability in its fiscal year 1986 financial statements and budget documents for the amount of default payments it expected to incur in fiscal year 1987. No such liability was shown for prior fiscal years, although generally accepted accounting principles for federal agencies required that one be estimated. Our report recommended that Marad document the process used for estimating the liability for potential future defaults; Marad has agreed to carry out this recommendation. Use of the documentation during the independent review of the estimating process would provide Marad management with an internal control to assure that the process is working as intended.

We also recommended that Marad's annual report clearly state that the Fund is no longer self-supporting. This statement is needed because revolving funds are intended to be generally self-supporting rather than being maintained with Treasury borrowings. Marad believes that the Fund's condition is clearly displayed, since its fiscal year 1986 annual report (dated June 1987) shows that expenses exceeded revenues and indicated borrowings from the Treasury.

We agree this would be sufficient if the Fund was in a position to repay its borrowings without the aid of appropriations. Prior to fiscal year 1985, Marad borrowed four times from the Treasury to cover default payments and in each case repaid the borrowings without seeking an appropriation. However, Marad has not generated sufficient revenues to repay the borrowings that started in fiscal year 1985 and continued through 1987.

Since 1985, Marad has not been able to repay its borrowings from the Treasury, relying instead on congressional appropriations. Therefore, we continue to believe that Marad's annual report should acknowledge its reliance on congressional appropriations by clearly stating in its annual report that the Federal Ship Financing Fund is no longer self-supporting. Marad officials advised us on October 7, 1987, that the 1987 annual report will contain a statement that the Fund was not self-supporting in fiscal year 1987. The report is scheduled to be issued in 1988.

Management Information On Extent Of Portfolio At Risk Of Default

The identification of companies with loan guarantees that are at risk of default is critical to assessing how much of the title XI portfolio is at risk. Marad usually prepares a monthly report--called the credit watch report--as a management information and tracking tool to monitor the companies judged to be at risk of default and their progress in overcoming their financial difficulties.[4]

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[4] In addition to information on companies at risk of default, this report contains other data, including the value and composition of the portfolio, and types and status of vessels obtained from companies that have defaulted on their loan repayments.

Although Marad officials initially told us that the report contained a complete list of companies at risk of default, we later learned that the report omitted certain companies. The examples below illustrate the discrepancies we found for two of the reports:

Date of report	Companies in report	Loan guarantee balances (in millions)	Companies omitted from report	Loan guarantee balances of omitted companies (in millions)
Nov. 1985	44	$939	14	$700
Dec. 1986	21	351	34	603

When this additional information was added, the portion at risk of default increased from $939 million to $1.6 billion for November 1985, and from $351 million to $954 million for December 1986. (See att. IV for further information on the portion at risk of default on September 30, 1986.)

When we asked Marad officials why they did not routinely compile complete data on companies at risk of default, they told us they were satisfied to rely on their staff to provide data as needed. They also said that program managers were aware that no complete list of companies at risk of default existed, and therefore this would not hinder Marad in managing the program. However, we believe the credit watch report would be a more useful management tool if it reflected all of the companies Marad considers at risk of default.

The process by which its loan examiners determine that a company is at risk of default and should therefore be placed on the credit watch report also needs to be documented. This action will provide better assurances that management judgments about the extent of the portfolio at risk of default, including needs for Treasury borrowings, are based on complete and credible information. This in turn would provide Marad management with a better basis to determine whether Treasury borrowings are needed.

Both the Department of Transportation's comments on a draft of our August report and Marad officials' January 1987 comments advised us that action will be taken to make the credit watch report complete. We met with Marad officials on October 7, 1987; they advised us that a complete listing of companies at risk of default with information on their circumstances has been prepared. We will evaluate that listing to determine whether it complies with our recommendation.

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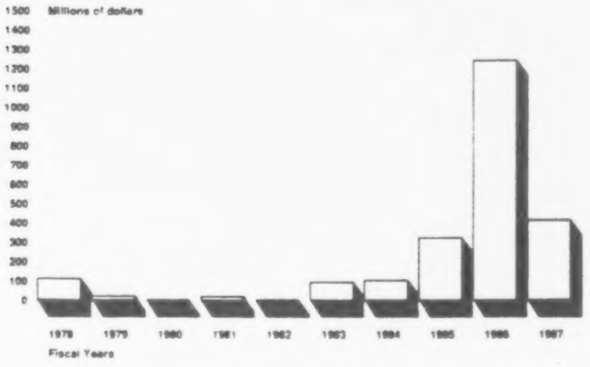
In summary, Mr. Chairman, the pace of defaults has declined over the past year, but the Fund continues to experience serious financial difficulty. The Fund is not currently in a position to repay its expenses, including Treasury borrowings, without the aid of congressional appropriations. The corrective actions Marad has taken or plans to take to improve its financial reporting and management information will yield benefits to the Congress. They will result in more useful and complete information being available to support congressional policy-making on the future of this program and Marad requests for supplemental appropriations.

This concludes my testimony, Mr. Chairman. I will be happy to answer any questions you or other Subcommittee members may have at this time.

ATTACHMENT I ATTACHMENT I

DEFAULT PAYMENTS FROM THE FEDERAL SHIP FINANCING FUND, FISCAL YEARS 1978-87



Note 1987 data represents payments through Sep 24 1987 only

ATTACHMENT II ATTACHMENT II

VALUE OF TITLE XI LOAN GUARANTEES AND COMMITMENTS, FOR SELECTED PERIODS, BY INDUSTRY SEGMENT

Segment	Year end, fiscal year				
	1983	1984	1985	1986	1987[a]
	in millions				
Liner[b]	$1,113	$1,087	$ 985	$ 822	$ 546
Bulk					
Tanker	2,032	1,903	1,772	1,603	1,396
Dry bulk	394	378	363	340	383
Liquefied natural gas	1,225	1,182	1,013	772	744
Drill rig	996	869	698	306	228
Drill supply	362	330	258	91	74
Inland[c]	1,493	619	567	448	344
Coastal[c]		709	631	483	381
Other	228	225	235	166	283
Total[d]	$7,843	$7,302	$6,522	$5,031	$4,378

[a] Through August 31, 1987.

[b] Includes lighter aboard ship (LASH) and Seabee barges.

[c] Figure for fiscal year 1983 includes inland and coastal.

[d] Individual components may not sum to total, due to rounding.

Source: Maritime Administration.

ATTACHMENT III

ATTACHMENT III

PORTION OF TITLE XI GUARANTEED LOANS AND COMMITMENTS, BY INDUSTRY SEGMENT, FOR SELECTED PERIODS

Segment	Year end, fiscal year				
	1983	1984	1985	1986	1987[a]/
Liner[b]/	14%	15%	15%	16%	12%
Bulk					
Tanker	26	26	27	32	32
Dry	5	5	6	7	9
Liquefied natural gas	16	16	16	15	17
Drill rig	13	12	11	6	5
Drill supply	5	5	4	2	2
Inland[c]/	19	8	9	9	8
Coastal[c]/		10	10	10	9
Other	3	3	4	3	6
Total[d]/	100%	100%	100%	100%	100%

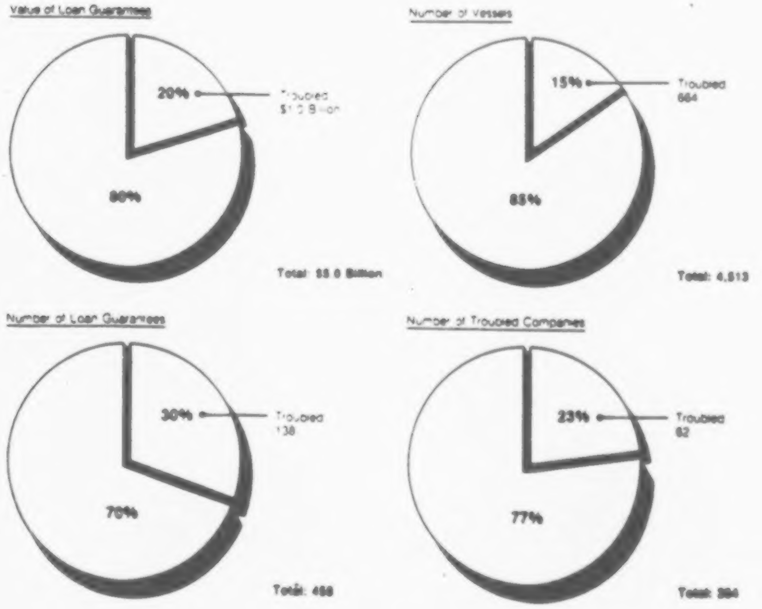
[a]/Through August 31, 1987.
[b]/Includes lighter aboard ship (LASH) and Seabee barges.
[c]/Figure for fiscal year 1983 includes inland and coastal.
[d]/Individual components may not sum to total, due to rounding.

Source: Maritime Administration.

ATTACHMENT IV

ATTACHMENT IV

PORTION OF TITLE XI LOAN GUARANTEES AND COMMITMENTS, COMPANIES, AND VESSELS AT RISK OF DEFAULT, AS OF SEPTEMBER 30, 1986



GAO

United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-229645/001

December 7, 1987

The Honorable Glenn M. Anderson
Acting Chairman, Subcommittee
on Merchant Marine
Committee on Merchant Marine
and Fisheries
House of Representatives

Dear Mr. Chairman:

In testimony during the Subcommittee's October 15, 1987, hearing,[1] we provided our preliminary views on H.R. 1037. This letter provides our further thoughts on the bill.

The bill provides that a federal department or agency may not acquire, construct, or arrange for the construction of a noncombatant vessel until it certifies to the General Accounting Office (GAO) that no suitable vessel can be obtained from the Maritime Administration or other federal department or agency.

We believe that the most appropriate recipient of the type of certifications contemplated by this bill would be a central management agency in the executive branch, such as the Office of Management and Budget or the General Services Administration. In addition, the bill does not state what the agency that receives these certifications should do with them. Accordingly, we recommend that the bill be revised to designate an executive branch central management agency as the recipient of the certifications and to specify the responsibilities of that agency with respect to the certifications it receives.

We appreciate the opportunity to provide our views on this bill. We would be pleased to discuss our comments with you should you desire.

Sincerely yours,

J. Dexter Peach
Assistant Comptroller General

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[1] Maritime Administration's Federal Ship Financing Program (GAO/T-RCED-88-1).

STATEMENT OF ELAINE L. CHAO, DEPUTY MARITIME ADMINISTRATOR OF THE DEPARTMENT OF TRANSPORTATION, BEFORE THE SUBCOMMITTEE ON MERCHANT MARINE OF THE HOUSE MERCHANT MARINE AND FISHERIES COMMITTEE ON THE TITLE XI GUARANTEE PROGRAM, AND ON H.R. 1037, A BILL "TO REQUIRE THAT DEPARTMENTS AND AGENCIES OF THE UNITED STATES OBTAIN SUITABLE VESSELS OWNED BY AND AVAILABLE FROM THE MARITIME ADMINISTRATION OR ANY OTHER DEPARTMENT OR AGENCY BEFORE ACQUISITION OR CONSTRUCTION OF ANY NEW NONCOMBATANT VESSEL."

OCTOBER 15, 1987

MR. CHAIRMAN, AND MEMBERS OF THE SUBCOMMITTEE ON MERCHANT MARINE. MY NAME IS ELAINE CHAO, AND I AM THE DEPUTY MARITIME ADMINISTRATOR OF THE DEPARTMENT OF TRANSPORTATION (DOT). IT IS A PLEASURE FOR ME TO APPEAR THIS MORNING AT YOUR OVERSIGHT HEARING ON THE TITLE XI GUARANTEE PROGRAM. MY TESTIMONY WILL INCLUDE COMMENTS ON THE MAJOR ACCOMPLISHMENTS WHICH HAVE BEEN MADE IN THE STRENGTHENING OF THAT PROGRAM DURING THE CURRENT DEPRESSION IN THE MARITIME INDUSTRY AND THE MAGNITUDE OF BANKRUPTCIES THAT HAVE PLAGUED THE TITLE XI PROGRAM. IN CLOSING, I WILL ALSO COMMENT ON H.R. 1037, A BILL DESIGNED TO ASSIST IN THE EFFICIENT AND ECONOMICAL USE OF EXISTING VESSELS, INCLUDING DEFAULTED TITLE XI VESSELS, THAT ARE SURPLUS TO THE REQUIREMENTS OF GOVERNMENT AGENCIES.

FIRST, I WILL ADDRESS THE TITLE XI GUARANTEE PROGRAM. MR. CHAIRMAN, THE LAST TIME THE DEPARTMENT APPEARED BEFORE YOUR SUBCOMMITTEE ON OVERSIGHT OF THE TITLE XI GUARANTEE PROGRAM WAS ON JUNE 25, 1985 -- OVER TWO YEARS AGO. AT THAT TIME THE TITLE XI PROGRAM WAS ADVERSELY AFFECTED BY THE WORST MARITIME DOWN TURN IN HISTORY, AND APPROXIMATELY 20% OF THE TITLE XI PORTFOLIO DEFAULTED OR WAS AT SIGNIFICANT RISK. WE ARE CAUTIOUSLY OPTIMISTIC NOW THAT THE RISK PORTION OF OUR CURRENT $4.3 BILLION PORTFOLIO HAS DROPPED SIGNIFICANTLY.

SINCE THE ADMINISTRATOR AND I JOINED THE AGENCY, ONE OF OUR KEY AREAS OF CONCERN HAS BEEN THE LEVEL OF DEFAULTS IN OUR TITLE XI PORTFOLIO. IN THE PAST YEAR, WE HAVE INITIATED A NUMBER OF ACTIONS TO IMPROVE OUR MANAGEMENT OF THE EXISTING PORTFOLIO, STRENGTHEN THE AGENCY'S ABILITY TO BETTER ASSESS PORTFOLIO QUALITY, AND IMPROVE CUSTODIAL CARE AND TRACKING OF OUR INVENTORY OF DEFAULTED VESSELS.

THESE ACTIONS INCLUDE THE FOLLOWING: (1) REORGANIZING OUR STAFF TO DEAL WITH BANKRUPTCY AND WORKOUT SITUATIONS; (2) ESTABLISHING A SPECIAL ASSET SALES UNIT WHOSE SOLE RESPONSIBILITY IS THE DISPOSAL OF REPOSSESSED EQUIPMENT; (3) UPDATING THE AGENCY'S MANAGEMENT INFORMATION SYSTEM TO PROVIDE MORE TIMELY AND BETTER MANAGEMENT INFORMATION ON OUR EXISTING PORTFOLIO AND INVENTORY OF DEFAULTED EQUIPMENT; (4) IMPLEMENTING A MORE COORDINATED AND COMPUTERIZED COVENANT MONITORING SYSTEM TO PROVIDE ADDITIONAL EARLY WARNINGS OF TITLE XI COMPANIES ENCOUNTERING DIFFICULTIES; 5) INSTITUTING A PORTFOLIO-WIDE RISK CATEGORIZATION SYSTEM, AND 6) IMPLEMENTING AN EFFICIENT, NEOTERIC CUSTODIAL PROGRAM FOR DEFAULTED LAID-UP ASSETS TO OPTIMIZE THE RESALE VALUES AND THUS RETURN TO THE U.S. TAXPAYERS.

IN ADDITION TO THESE MANAGEMENT IMPROVEMENTS, A SIGNIFICANT TITLE XI DEVELOPMENT HAS BEEN THE ENACTMENT OF BANKRUPTCY LEGISLATION (SECTION 5001 OF PUBLIC LAW 99-509) ON OCTOBER 21, 1986. WHEN WE APPEARED TWO YEARS AGO, WE INFORMED THE SUBCOMMITTEE OF THE INABILITY OF DOT, AS A TITLE XI MORTGAGEE, TO TAKE TIMELY FORECLOSURE ACTION ON A DEFAULTED TITLE XI MORTGAGE. THE SECRETARY DID NOT HAVE THE ABILITY TO PROTECT THE GOVERNMENT'S FINANCIAL INTEREST BY RECOVERING THE COLLATERAL VALUE OF THE VESSELS, BECAUSE ALMOST ALL OF THE DEFAULTED TITLE XI VESSELS WERE BEING OPERATED BY THEIR OWNERS UNDER THE PROTECTION OF THE BANKRUPTCY COURTS. THOSE VESSELS WERE BEING OPERATED IN MOST CASES WITH NO CAPITAL COST TO COVER, BECAUSE THEY HAD DEFAULTED AND HAD BEEN PAID OFF. THEIR CONTINUED OPERATION WAS CAUSING SIGNIFICANT INJURY TO THE REMAINDER OF THE INDUSTRY, INCLUDING THOSE TITLE XI OPERATORS WHO CONTINUED TO HONOR THEIR FINANCIAL COMMITMENTS. THE BANKRUPTCY LEGISLATION AMENDED SECTION 362 SO THAT AFTER 90 DAYS BOTH DOT AND THE DEPARTMENT OF COMMERCE HAVE THE AUTHORITY TO FORECLOSE. THIS LEGISLATION WILL EXPIRE BY ITS TERMS ON DECEMBER 31, 1989.

THERE HAVE BEEN ENCOURAGING ASPECTS OF THIS LEGISLATION WHICH SHOULD NOT GO UNNOTICED. CARRIERS IN FINANCIAL TROUBLE ARE NOW MUCH MORE INCLINED TO ATTEMPT TO FIND WORKOUT SOLUTIONS WITH US THAN IN THE PAST. ADDITIONALLY, IT HAS HELPED SIGNIFICANTLY

IN GETTING ADEQUATE PROTECTION PAYMENTS FOR VESSELS OPERATING IN BANKRUPTCY, AS WELL AS ACCELERATING THE FILING AND DEVELOPMENT OF CHAPTER 11 REORGANIZATION PLANS.

YOU SHOULD ALSO BE AWARE, HOWEVER, THAT SOME OF THE BANKRUPTCY COURTS WHICH CONSIDERED THIS ISSUE HAVE ENJOINED US FROM FORECLOSING AFTER 90 DAYS ON DEFAULTED TITLE XI VESSELS WHOSE OWNERS HAD FILED FOR PROTECTION UNDER CHAPTER 11 OF THE BANKRUPTCY CODE. THE COURTS' RATIONALE APPEARS TO BE THAT THE OPPORTUNITY FOR A DEBTOR TO REORGANIZE UNDER CHAPTER 11 OUTWEIGHS THE RIGHT OF THE GOVERNMENT TO FORECLOSE UNDER 11 U.S.C. 362. WE BELIEVE THAT THESE BANKRUPTCY COURT DECISIONS CONTINUE TO UNDULY FAVOR THE DEBTOR AT THE EXPENSE OF THE TAXPAYER, AND ADVERSELY AFFECT THE CAREFULLY DRAWN BALANCE CONGRESS STRUCK BETWEEN THE INTERESTS OF MARITIME DEBTORS AND THE DEPARTMENTS OF TRANSPORTATION AND COMMERCE. WE BELIEVE THAT CONGRESS DID NOT INTEND THE COURTS TO ENJOIN THE GOVERNMENT IN THE EXERCISE OF ITS POWERS UNDER SECTION 362 OF THE BANKRUPTCY CODE, AND THEREFORE WE ARE PURSUING APPEALS OF THESE DECISIONS. DEPENDING ON THE OUTCOME OF THESE APPEALS, WE MAY NEED ADDITIONAL LEGISLATIVE LANGUAGE.

MR. CHAIRMAN, I WOULD NOW LIKE TO RESPOND TO YOUR REQUEST FOR THE ADMINISTRATION'S VIEWS ON THE SEPTEMBER 14, 1986 REPORT OF THE DOT INSPECTOR GENERAL ON THE MARITIME ADMINISTRATION'S MANAGEMENT OF THE TITLE XI GUARANTEE PROGRAM AND THE RECENT GENERAL ACCOUNTING OFFICE (GAO) REPORT CONCERNING THIS PROGRAM.

THESE REPORTS COVERED A WIDE VARIETY OF ASPECTS OF OUR TITLE XI PROGRAM WHICH I NEED NOT OUTLINE HERE.

WHAT IS IMPORTANT TO NOTE MR. CHAIRMAN, IS THAT THESE REPORTS HAVE BEEN MOST HELPFUL IN REINFORCING THE ADMINISTRATOR'S AND MY EFFORTS TO IDENTIFY AND IMPLEMENT IMPROVEMENTS IN THE MANAGEMENT OF THE TITLE XI GUARANTEE PROGRAM. THE AGENCY HAS ALREADY COMPLIED WITH THE RECOMMENDATIONS IN THE DOT INSPECTOR GENERAL'S AUDIT, AND HAS BEEN OR IS COMPLYING WITH THE GAO RECOMMENDED IMPROVEMENTS IN FINANCIAL AND ACCOUNTING REPORTING.

FINALLY, MR. CHAIRMAN, YOU HAVE REQUESTED OUR VIEWS ON H.R. 1037. THE BILL WOULD APPEAR TO HAVE MERIT, AS IT WOULD ASSIST DEPARTMENTS AND AGENCIES, INCLUDING DOT, IN DISPOSING OF VESSELS SURPLUS TO THEIR REQUIREMENTS, AND SHOULD RESULT IN OVERALL SAVINGS TO THE FEDERAL GOVERNMENT.

MR. CHAIRMAN, AS YOU KNOW THE EFFICIENT DISPOSAL OF DEFAULTED TITLE XI EQUIPMENT HAS BEEN A PROBLEM, AND WE DEEPLY APPRECIATE THE INTEREST OF THIS SUBCOMMITTEE, AND CONGRESSMAN LOWRY IN PARTICULAR, IN PROPOSING H.R. 1037. HOWEVER, IT NOW APPEARS THAT SUCH LEGISLATION MAY NOT BE REQUIRED.

FOR NONMARTIME EQUIPMENT FOR AGENCIES OTHER THAN DOT, AN ADMINISTRATIVE PROCESS ALREADY EXISTS THROUGH THE GENERAL SERVICES ADMINISTRATION TO ASSURE THE COORDINATION PROPOSED IN THE BILL. WITH RESPECT TO DOT, AND SPECIFICALLY THE MARITIME ADMINISTRATION, TITLE XI OF THE MERCHANT MARINE ACT, 1936, GIVES US SPECIAL AUTHORITY FOR DISPOSING OF DEFAULTED TITLE XI EQUIPMENT. THE INTRODUCTION OF H.R. 1037 HAS SERVED TO FURTHER SENSITIZE US IN RECOGNIZING AN AREA WHERE ADDITIONAL COORDINATION WITHIN THE GOVERNMENT WOULD BE HELPFUL, AND WE ARE CURRENTLY WORKING WITH OMB AND OTHER AGENCIES TO ACHIEVE THIS RESULT ADMINISTRATIVELY. WE HAVE STRONG REASONS TO BELIEVE THAT THIS EFFORT WILL BE SUCCESSFUL, SO THAT LEGISLATION WOULD NOT BE REQUIRED. THEREFORE, MR. CHAIRMAN, WE RESPECTFULLY REQUEST THAT FURTHER ACTION ON H.R. 1037 BE DEFERRED FOR AT LEAST 30 DAYS UNTIL WE HAVE HAD A REASONABLE OPPORTUNITY TO DETERMINE WHETHER OUR MUTUAL GOALS CAN BE ACCOMPLISHED ADMINISTRATIVELY.

MR. CHAIRMAN, THAT CONCLUDES MY PREPARED STATEMENT. I WILL BE PLEASED TO ANSWER ANY QUESTIONS THAT YOU OR THE MEMBERS OF THE SUBCOMMITTEE MAY HAVE. THANK YOU.

QUESTIONS SUBMITTED BY THE HONORABLE MIKE LOWRY, MEMBER, COMMITTEE ON MERCHANT MARINE AND FISHERIES, TO THE HONORABLE JOHN GAUGHAN, ADMINISTRATOR, MARITIME ADMINISTRATION; AND ANSWERS RECEIVED FROM MR. GAUGHAN, DATED JANUARY 29, 1988

Question No. 1: Based on the court decision from the Gramm-Rudman case, I believe that we have to amend this legislation and choose another agency besides GAO. What agency would you suggest? OMB?

Answer:

Yes, we would suggest that OMB should be substituted for the GAO in light of the Supreme Court decision in Bowsher v. Synar, 106 S. Ct. 3181 (1986). The Court held in that case the Comptroller General's role in exercising executive functions under the deficit reduction process (Gramm-Rudman-Hollings Deficit Reduction Act) violated the doctrine of separation of powers. Moreover, the Deficit Reduction Act was recently amended by Public Law 100-199 to specify OMB as the appropriate agency.

However, we believe that an administrative process would be a better means to implement the goals of H.R. 1037. We are currently working with OMB and other agencies to achieve administratively the results intended by H.R. 1037.

Question No. 2: According to CBO, this legislation has no savings for purposes of reconciliation because, according to CBO, most agencies were already cooperating with MARAD and the tractor tugs which could possibly be used by the Panama Canal Commission had already been sold. In your opinion, does this legislation save any money? If so, how much?

Answer:

We believe that the objective of this legislation could be served better by administrative efforts with other agencies. Better administrative inter-agency coordination could save the Government both money and time in its efforts to meet its vessel needs. In the absence of specific projects or an evaluation of projected vessel needs, however, it is difficult to quantify the savings that could result from the use of MARAD vessels.

However, newbuilding costs, even in today's market, substantially exceed the cost of a used vessel, even with modifications. An indication of this is the significant number of vessels sold to the fishing industry by MARAD. Even though these vessels need substantial modification, the delivered cost is significantly less than a newbuilding.

Question No. 3: Last year, in discussions with MARAD, I was told that most agencies, such as the Navy were cooperating with you and were purchasing vessels from you. Is this still the case?

Answer:

Generally, most of our sale discussions with other agencies have been with the Navy or State Department. The Navy has been very cooperative and in fact has purchased a number of vessels from us. State's interest has been primarily on behalf of less developed countries. Although State has been very cooperative, no vessels have yet been purchased as a result of our joint efforts.

Question No. 4: Are there any vessels that you know of that were purchased new by an agency where there was a MARAD vessel that could have met the performance requirements?

Answer:

We continue to believe that the tractor tugs, with modifications, could have been delivered to the Panama Canal Commission in a shorter time frame and at a lower cost than new buildings. The Panama Canal Commission strongly disagrees with this view, sent inspection teams to examine each of the tugboats in question, and concluded that even with modifications the tugboats offered would fail to meet the unique requirements for vessels operating in Canal Waters.

We have also been made aware of new barge constructions where the specifications were only slightly different from vessels MARAD was in the process of foreclosing. We are not familiar enough with the time constraints the acquiring agency was under to comment fairly whether the requirements were overly restrictive or otherwise precluded consideration of MARAD financed equipment.

Question No. 5: Concerning the purchase of the tractor tugs by the Panama Canal Commission (PCC). Could the tugs, with modifications, have met the performance requirements of the PCC? What were some of the problems with the tugs? What would have been the cost, with modifications, of these tugs to the PCC? How old were these tugs?

Answer:

MARAD and the Panama Canal Commission disagree over whether the tugs, with modifications, would have met the performance requirements for operating in the Panama Canal. MARAD believes that the tractor tugs with modifications could have met all the performance requirements specified in Solicitation P-98-23 issued by the Panama Canal Commission, (except for two items: (1) active dual controls and (2) an enclosed machinery space operating station). Most of the work involved reconditioning and relocating equipment with the overall cost of modifications estimated at $1.2 million per tug. MARAD was prepared to offer tugs to the Commission at an approximate total cost of $2.7 million. The tugs were originally delivered in 1982.

The Commission's Technical Evaluation Team inspected seven MARAD tugs. The two deemed by MARAD to be most likely to meet Commission requirements were found deficient in the areas of operations, safety, maintenance, repair and training. The Commission received an unsolicited offer from Cameron Shipbuilding to do the work for $2.225 million per tug. This cost would be in addition to the acquisition cost by the Commission.

Question No. 6: MARAD is charged with both promoting the domestic maritime industry and with selling assets to lower economic risks to the taxpayers. It is an understatement to suggest that these two goals are conflicting. How is MARAD resolving this conflict? Is there a way Congress could help resolve some of these problems?

Answer:

MARAD has worked arduously to resolve this conflict. We have diligently sought to sell equipment to alternative uses and to other agencies. We have had great success in selling to the fishing industry, for example. Additionally, we have commissioned independent studies to better evaluate markets, the recovery in those markets and the ability of those markets to absorb vessels. This has helped guide our sales efforts. We have also developed long-term layup procedures to maintain assets at minimal costs pending market recovery. This has enabled us to reduce our holding costs, prevent dumping into a poor market and maximize our recovery through better timing of sales.

Statement Of
W. Patrick Morris
Vice President and General Counsel
Shipbuilders Council of America
Before
Subcommittee on Merchant Marine
Committee on Merchant Marine and Fisheries
on Title XI
Federal Ship Financing Program
October 15, 1987

Mr. Chairman, Members of the Subcommittee on Merchant Marine. I am W. Patrick Morris, Vice President and General Counsel of the Shipbuilders Council of America. The Council, the national trade organization representing the principal domestic shipbuilders, ship repairers, and the vendors of materials and services to those industries, appreciates the opportunity to express its views on the Federal Ship Mortgage Guarantee Program authorized by Title XI of the Merchant Marine Act of 1936, as amended. A listing of the membership of the Council is attached.*

The Council does not have a position on H.R. 1037, Congressman Lowry's bill to require federal agencies, prior to acquiring or constructing any new noncombatant vessel, to certify to the General Accounting Office that no vessel capable of satisfying the performance requirements of the intended mission is obtainable from the Maritime Administration or any other federal agency. On the basis of a cursory review of the language, however, I would personally question the need for the measure.

The Title XI Program, as we currently know it, has its genesis in the Federal Ship Financing Act of 1972 (P.L. 92-507). The legislation is intended to attract private debt capital for the construction of vessels in domestic shipyards by making the obligations more marketable. The United States Government guarantees the obligations sold to purchasers, rather than insuring a loan or mortgage as was done under the old program. All collateral runs directly to the Maritime Administration, including the preferred mortgage, and does not involve the purchasers of the obligations, the trustees, or other parties to the financing. In other words, the purchasers of the obligations rely on the full faith and credit guarantee of the United States Government printed on the face of each obligation.

The value of the United States Government guarantee depends on the credit rating of the owner of the vessel. Obviously, large companies with triple A credit ratings do not utilize the program because they can obtain competitive interest rates without the guarantee. However, smaller companies, who are poorer credit risks, can reduce their interest costs significantly. Privately-owned U.S.-flag shipping companies are, by and large, not viewed as high quality risks for debt financing by the investment community for a number of reasons, including their volatile earning patterns, high level of debt, and low return on capitalization. Thus, the availability of the Title XI Program has been very important to U.S.-flag operators because it allows them to modernize their fleet. Moreover, it benefits domestic shipyards because all the work on vessels must be performed in United States facilities.

The Title XI Program has provided guarantees to a number of vessel types over the years. The following chart, which was prepared from data acquired from the Maritime Administration, lists the type, number, actual cost of the vessel, and the mortgage amounts guaranteed through Fiscal Year 1986:

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*(Ed. Note: Listing can be found in Subcommittee files.)

Fiscal Year 1986

Type	No.	Actual Cost	Mortgage Amount
Tankers	130	$ 3,856,958,871	$ 3,139,574,060
Cargos	231	2,909,904,924	2,126,397,787
Cargo/Passenger	10	105,387,632	73,338,000
River Tugs	159	289,776,866	212,421,256
River Barges	3,526	963,984,110	763,054,812
Ocean Tugs	171	547,372,420	442,348,667
Ocean Barges	220	825,234,302	664,328,403
Shipboard Barges	3,792	221,665,582	169,950,620
Drill Rigs/Ships	98	1,971,381,047	1,443,793,369
Drill Service	237	646,086,456	535,672,018
LNGs	16	1,566,106,494	1,239,004,900
Bulk/OBOs	23	585,560,960	486,057,388
Miscellaneous	38	458,509,476	357,572,316
TOTALS:			
Vessels (excludes Shipboard Barges)	4,859	$14,756,593,389	$11,494,027,497
Lighters	3,546	191,335,750	159,486,100
	8,405	$14,947,929,139	$11,653,513,597

In August of this year, the General Accounting Office released a report examining the Title XI Program. The report, entitled "Efforts to Improve Data on the Federal Ship Financing Program," was done at the request of Congressman Anderson, the Acting Chairman of the Subcommittee. The report describes how economic conditions in two industries - oil and agricultural products - contributed to the rapid expansion and subsequent record defaults in the program. The Title XI portfolio increased from less than $2 billion at the end of fiscal year 1973 to more than $8 billion by the end of fiscal year 1982. In the 1980's, the price of oil declined dramatically and agricultural exports decreased resulting in depressed operating conditions for certain privately-owned vessels whose financing loans were guaranteed by the Maritime Administration.

Under the heading of "Troubled Loan Guarantees as a Portion of the Total," GAO found that at the end of fiscal year 1986 (Sept. 30, 1986):

- o 20 percent of the $5 billion in loans outstanding are "troubled";
- o 23 percent of the 264 companies with guarantees are "troubled"; and
- o 30 percent of the 458 loan guarantees are "troubled."

The principal finding of the report is that the Title XI Program is no longer maintained by fees paid by vessel purchasers, that is, it is no longer self-supporting. The program had been self-sustaining for years and this fact generated considerable favorable backing for it in both the Executive and Legislative branches. However, the program had a deficit of $250 million for fiscal year 1985 and borrowed over $1.2 billion from the Treasury to cover expenses for fiscal year 1986. As pointed out by GAO, these deficits are a direct result of the economic decline in the agriculture and oil industries. Until conditions in these markets improve, additional defaults will be unavoidable. The agency has learned from this lesson and is taking positive steps to avoid similar judgment errors in the future. Moreover, I understand that the Maritime Administration has adopted most of the recommendations made by GAO that will result in better overall management of the program.

It is an understatement to say that the Title XI Program has not been very popular with the Reagan Administration. Originally, limitations were sought on the amount of loan commitments which the agency could enter into in a given fiscal year. Conceivably, such limitations could have been rationally defended because of the rapidly changing market conditions. However, that figure ultimately reached zero in fiscal year 1986. On October 28, 1986, the program reached its nadir. On that date, President Reagan pocket vetoed H.R. 4175, the Maritime Authorization Act for Fiscal Year 1987, because the measure did not repeal the Title XI Program. It is my understanding that the Office of Management and Budget was the driving force behind the veto.

Fortunately, the Congress in general and this Subcommittee in particular has steadfastly refused to accede to the desires of the Administration with respect to the Title XI Program. On the contrary, you have been most supportive of the program and the Council applauds your action in this regard. The Title XI program remains as probably the most important maritime program designed to assist operators to finance the construction in domestic shipyards of complex, efficient merchant ships. At the present time, the Maritime Administration has ample unused guarantee authority at its disposal to carry out the program. The real issue is whether the agency possesses the willpower to implement a program which the Congress supports and the maritime industry desperately needs.

A number of applications, which would appear to have merit, are currently pending before the agency. For example, the American Ship Building Company recently filed an amended application for Title XI guarantee to assist in the financing of the construction of two 1,200 passenger cruise ships for the rapidly expanding inter-island Hawaiian trade. This multi-million dollar project represents the first viable endeavor to build in the United States large, modern, efficient passenger ships in three decades. Approval of the project by the Maritime Administration would greatly augment the economics of the project. The project represents over 2,000 shipyard jobs and will provide hundreds of seagoing billets over the life of the vessels.

The Shipbuilders Council urges this Subcommittee to continue to back the Title XI Program as a necessary tool to aid operators and shipyards in the highly competitive shipping world. This is the least you can do in the current environment.

This concludes my statement. I will attempt to answer any questions you might have. Thank you.

Attachment

Statement of Frank Drozak, President
Maritime Trades Department, AFL-CIO
Before the Subcommittee on Merchant Marine
Committee on Merchant Marine and Fisheries
October 15, 1987

The Maritime Trades Department, AFL-CIO, representing 43 national and international unions composed of 8.5 million workers, appreciates the opportunity to express our concerns regarding the Title XI Federal Ship Financing Program. Title XI represents one of the last remaining maritime promotional programs, and its survival has been tenuous. The reason for its plight is obvious.

Over the last seven years, the administration has been unwilling to accept the fact that the maritime industry is in the midst of a crisis and that its policies have significantly contributed to the industry's depressed state. Almost every maritime-related program for which federal funds must be appropriated has been slashed or eliminated. Last year, the president pocket-vetoed the Marad authorization bill for 1987 because it did not include a repeal of the Title XI program, which for years played a central role in the expansion and modernization of the U.S. merchant fleet.

In his veto message, President Reagan said, "The maritime industry must be encouraged to rely on the private credit market without federal intervention as its source of capital if we are to continue our progress toward restoring that industry to full health." I believe this statement, as clearly as any, demonstrates the administration's slavish allegiance to the imposition of free market principles on an industry that hasn't enjoyed the benefits of a free market environment in recent memory.

According to the just-released "First Report of the Commission on Merchant Marine and Defense: Findings of Fact and Conclusions", between 1982 and 1986, the shipbuilding and repair industry lost approximately 52,500 jobs, 76 shipyards and repair facilities, 22 building ways, 17 floating drydocks, 21 large graving docks and many plant facilities. At least 15 of the surviving firms are operating under Chapter 11 bankruptcy protection. The report further notes:

> The total collapse of commercial ship construction has been a major factor in the decline of United States shipbuilding capability. Government construction alone, mostly Navy and concentrated in a small number of shipyards, is insufficient to maintain a diversified shipbuilding and repair industry, including shipyard suppliers, sufficient to meet mobilization requirements in time of war or national emergency.... The shipbuilding mobilization base must be maintained to ensure that the demands of the national strategy can be met....
>
> Although the shipbuilding and repair industry would be able to meet the surge phase requirements during mobilization, the sustaining phase of mobilization would be constrained by shipyard facilities, manpower, and material supplier industries at different times in both 1987 and 2000. Adequate shipbuilding positions are not available to meet Navy or merchant marine new construction requirements during mobilization in either 1987 or 2000. Shipyard manpower is currently at a level that would constrain mobilization efforts beyond the surge phase, especially on the West Coast. Given current and projected capabilities, the shipyard supplier industries could not support mobilization new construction requirements in 1987 or in the year 2000.

The Title XI ship construction and mortgage insurance guaranty program is essential to compensate American shipbuilders, who must compete with foreign shipyards benefiting from massive subsidies, unfair trade practices and substandard wages. The program demonstrates our commitment to sustain a shipyard mobilization base and skilled manpower pool adequate to meet national emergencies.

It is well know that the Title XI program has recently experienced problems resulting from defaults within segments of the maritime industry. Indeed, these are problems well documented in the recently issued General Accounting Office report entitled "Efforts to Improve Data on the Federal Ship Financing Program." There are some who have sought to exploit these financial mishaps as a way of eliminating the program. This is a line of reasoning that the Maritime Trades Department categorically rejects.

As the above-mentioned report itself indicates, "Economic conditions in key industries -- oil and agricultural products -- contributed to the rapid expansion and subsequent record default payments in the program." Such conditions are beyond the control of any one operator, and do not indicate unsound business decisions by Title XI recipients.

Nor do such problems, which are transient in nature and impossible to fully anticipate, in any way negate the central role that the Title XI program has played in the expansion and modernization of the U.S.-flag merchant fleet. Several important projects are currently pending for which federal loan guarantees could mean the difference between success and failure. They demonstrate the difference that access to long-term fixed-rate financing from private capital markets makes for expanding U.S.-flag service into the many specialized trades and markets a thriving maritime sector needs.

The Title XI program is the necessary tool for bringing private capital into U.S.-flag vessel construction projects in domestic shipyards. Without the program, what little remains on ship order books would dry up, with no remedy in sight. To a shipbuilding industry already reeling from decades of continual decline and contraction, the absence of government guarantees for debt repayment would mean a death blow. To the security of the United States, it would mean reliance on foreign powers for a source of strategically essential vessels during times of war.

Mr. Chairman, the Title XI ship construction loan and mortgage insurance program represents the only manner in which opportunities for U.S.-flag service will be realized in specialized trades and developing markets. It is therefore an essential component of any strategy for revitalizing our merchant marine. The Maritime Trades Department will be pleased to work with the subcommittee in any way to ensure the program's continued full support.

U.S. Department of Transportation
Office of the Secretary of Transportation
Office of Inspector General

Memorandum

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Determined Under 5 U.S.C. 552

Subject: **ACTION**: Report on Audit of the
Management of the Federal Ship
Financing Guarantee Program
Report No. AV-MA-6-040

Date: September 4, 1986

From: for Wilbur L. Daniels
Joseph E. Kratz
Acting Assistant Inspector General for Auditing

Reply to Attn of: JA-20:366-4165

To: Associate Administrator for Administration

Attached is our final report on the Maritime Administration's (MARAD) Management of the Federal Ship Financing Guarantee Program. The audit was performed to evaluate: (1) MARAD's financial management practices relative to the Federal Ship Financing Fund (FSFF), (2) the adequacy of decisions to provide assistance to financially troubled companies, and (3) MARAD's actions to maintain and dispose of vessels obtained through defaults.

We concluded that MARAD's financial management practices contributed to the $1 billion deficit balance in the FSFF. In addition, assistance provided to financially troubled companies has been unsuccessful and MARAD can reduce its costs for maintaining vessels obtained through default. MARAD's decisions to permit restructuring of loan terms and conditions under loan guarantees were not always based on detailed cost/benefit analyses. Such analyses should also be prepared and used as the basis for determining the action to be taken on projects for which MARAD has assumed control of the vessels. Certain investments in vessel conversions contrary to the results of such analyses resulted in default of loan guarantees and necessitated additional borrowings of $75 million from the U.S. Treasury. Also, the most economical location to store defaulted vessels had not been based on detailed cost comparisons, and MARAD needs to establish guidelines for self-insurance of such vessels to realize potential annual savings to the FSFF of $1.8 million.

MARAD's officials generally disagreed with the findings and recommendations in the draft report. Based on their response, some revisions were made to this report. They indicated that the recommended actions were in place prior to the audit. Our audit results, however, disclosed that additional emphasis is needed regarding MARAD's management of the FSFF, and actions taken concerning the fund's management need to be properly documented.

In accordance with DOT Order 8000.1B, paragraph 6e, please advise this office within 90 days of the date of this report of the specific actions taken or planned regarding the audit findings and recommendations contained in this report. I appreciate the courtesies and cooperation extended to my staff during the audit.

Attachment

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Determined Under 5 U.S.C. 552

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Release to the Public of Contractor/
Grantee Information Contained In This
Report May Be Prohibited by 18 U.S.C.
1905

I. INTRODUCTION AND SCOPE

The Office of Inspector General performed an audit to evaluate the effectiveness of the Maritime Administration's (MARAD) policies and practices in managing selected aspects of the Title XI program. The objectives of the audit were to evaluate: (1) financial management practices relative to the Federal Ship Financing Fund (FSFF), (2) the adequacy of decisions to provide assistance to financially weak companies, and (3) actions to maintain and dispose of vessels obtained through defaults.

The audit covered management actions taken during Fiscal Year (FY) 1985 and other periods, as necessary. Our review focused on policies, practices, and management actions involving attempts to prevent defaults. We also evaluated the potential for the FSFF to become viable. Approval of loan guarantee commitments was not included in the scope of the audit because MARAD has recently implemented new approval procedures and the number of these loans have decreased significantly. The audit was performed in accordance with the General Accounting Office "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions" and included such tests as considered necessary in the circumstances.

II. RESULTS OF AUDIT

Available balances in the FSFF have not been adequate to support Title XI ship loan guarantee commitments. MARAD has chosen to finance the FSFF deficits through borrowings from the Treasury rather than seeking direct appropriations from the Congress. As of December 31, 1985, the fund had borrowed $450 million from the Treasury with additional borrowing of $800 million anticipated to meet FY 1986 defaults. By the end of 1986 interest expense will exceed projected revenues. (See page 3.)

MARAD's action--permitting vessel owners to facilitate repayment--has been ineffective, and has increased the liability of the FSFF. About 57 percent of the companies reviewed during the 15-month period ended October 31, 1985, have either defaulted or MARAD has assumed the loan. As a result, these actions could increase losses of the FSFF by $20 million. (See page 6.)

MARAD used insurance proceeds to convert two liquefied natural gas (LNG) tankers to dry bulk carriers rather than sell or scrap the vessels and liquidate the Title XI debt. As a result of the project approval, MARAD had to borrow an additional $75 million from the Treasury because the insurance proceeds had been used for ship conversion. (See page 11.)

MARAD formed a company to purchase four LNG tankers without performing sufficient analysis to determine if other alternatives such as direct assumption of the debt or default would have been more cost-effective. This action increased the costs of the FSFF by about $1 million for legal, accounting, and administrative fees. (See page 14.)

Progress payments made to a shipbuilder for two barges were excessive. Percentages of completion were overstated and, at one point, the overpayments totaled $4.1 million. MARAD remedied the situation through discontinuance of payments and an increase in the contract price. MARAD also decided to complete one of the barges although the results of independent market surveys indicated that a buyer was not readily available. The cost to complete the barge was approximately $5 million for which MARAD received no benefit. The completed barge was eventually sold for $7.5 million. (See page 16.)

MARAD has not made cost comparisons to determine the most economical location to store defaulted vessels. Annual storage and insurance costs were incurred of about $3.8 million and $.5 million, respectively. These defaulted vessels have limited resale value. We estimate for these vessels that savings of up to $1.3 million, annually, could be realized by using National Defense Reserve Fleet sites to store defaulted vessels. Furthermore, providing self-insurance could save an additional $500,000 annually. (See page 19.)

Based on MARAD's response to the draft report, some revisions were made to this final report. Although MARAD officials generally did not agree with the findings and recommendations, we recommend that they reconsider their position along with the revisions to this report.

FINDINGS AND RECOMMENDATIONS

Finding A. Status of Federal Ship Financing Fund

The Federal Ship Financing Fund (FSFF) does not have sufficient funds to support Title XI ship loan guarantee commitments. Changes in market conditions have reduced the demand for vessels which in turn has increased the number of guaranteed loan defaults. Instead of requesting the Congress to appropriate funds to make the FSFF solvent, MARAD has borrowed significant amounts from the Treasury and the need for such borrowing has steadily increased. As of December 31, 1985, the fund had borrowed $450 million from the Treasury to meet Title XI obligations with as much as $800 million anticipated to cover additional FY 86 defaults. By the end of 1986, interest expense for the fund will exceed projected revenue. Continuing to increase the FSFF's balance through borrowings which MARAD cannot repay, hampers its support for the maritime industry and allows uncollectible receivables to remain on the Treasury's books.

Discussion

Title XI of the Merchant Marine Act of 1936, as amended, authorizes MARAD to guarantee ship mortgages for vessels in the maritime fleet. The vehicle for guaranteeing loans is the FSFF. This fund is used to honor defaulted loans, assist shipowners with short-term cash needs in meeting operating costs, and pay for administrative costs. Revenue to sustain the fund is generated primarily from investigation fees, loan guarantee fees, interest, and sale of vessels.

In recent years, the FSFF has experienced significant losses due to defaults. As of the first quarter of FY 1986, the fund has incurred over $880 million in defaults. About 95 percent of this amount is due to defaults occurring in the 5-year period ending December 31, 1985. Because MARAD foresaw a need to borrow funds to cover potential losses, a promissory note was executed with the Treasury in February 1985. Under the terms of the note, interest is payable semiannually with repayment of principal within 10 years from the beginning of each fiscal year in which funds are borrowed. In July 1985, MARAD initially borrowed $35 million. Between July and December 1985 a total of $450 million had been borrowed. According to MARAD projections, an additional $800 million may be needed to cover future FY 1986 borrowings.

Based on projected revenues, the FSFF cannot become solvent or even meet its debt service. Such projections for FY 1986 total $52.8 million in revenues and expected expenses, including advances, total $92.8 million. These revenues do not include any income from the sale of vessels obtained through default. This source of revenue is not anticipated as significant in the immediate future, since MARAD has title to only 2 of 134 defaulted vessels. Further, the current oversupply of vessels limits resale potential. Evaluating sales of vessels between 1980 and 1985, recoveries ranged from 4 to 63 percent and averaged only 47 percent of the Title XI guarantee amount paid. Another source of revenue for the fund is repayment of advances made to firms. However, advances outstanding were $106 million as of December 31, 1985, and about 50 percent are considered collectible.

In summary, according to projections, by the end of FY 1986 the FSFF will have borrowed between $820 million and $1.2 billion from the Treasury. By that time, the payments to the Treasury for interest will exceed anticipated revenues. This financial crisis has occurred at a most inopportune time for loan repayment. For example, the largest single revenue source for the FSFF, guarantee fees, will continue to decrease because very few new guarantee loan applications are being approved by MARAD in FY 1986. In FY 1987, MARAD plans to make no new Title XI loan guarantee commitments. In addition, opportunities to sell defaulted vessels at a break-even price are also unlikely because the supply of vessels exceeds the demand, especially in the oil and grain segments of the maritime industry.

Title XI defaults represent legal obligations of the Government, and the Treasury must support the FSFF's deficit. Title XI advances are recorded as an interdepartmental receivable. Showing a receivable on the books of the Treasury indicates that the FSFF will eventually recover and repay the loan to the Treasury. However, since the fund will unlikely ever repay the Treasury, continuing to carry a receivable could affect budgetary management decisions.

Recommendations

We recommend that MARAD:

1. Request an appropriation from Congress to liquidate the debt owed to the Treasury by the FSFF.
2. Make annual projections of FSFF revenues and expenses, and request appropriations for any anticipated shortfalls.

Management Comments

MARAD officials did not agree with the recommendations. They prefer to delay the writeoff of the FSFF debts to the Treasury until the majority of the defaults have taken place and there will not be a need for future borrowing. MARAD also did not agree that 50 percent of the advanced are uncollectible because collection efforts are still being pursued. They did agree, however, that selling defaulted vessels at break-even prices is unlikely, although sales have been made of such vessels for less than the payoff amount. (The entire response is provided as an Appendix to this report.)

Audit Comments

Delaying recognition of FSFF losses until a date to be determined sometime in the future, perpetuates the current system and continues showing questionable receivables on the books of the U.S. Treasury. The dollar value of defaults will exceed projected amounts during FY 1986. In January 1986, MARAD projected in the worst case scenario that the debt to the Treasury at the end of FY 1986 would be $1.2 billion. However, as of June 30, 1986, the actual amount borrowed from the Treasury was about $1.3 billion with additional defaults expected before the end of FY 1986. Several more years may be required before the bulk of the defaults occur. As of November 1985, MARAD identified 28 financially troubled companies that may default on their loans.

The statement that about 50 percent of the receivables are considered uncollectible is based on MARAD's list of "good" receivables. MARAD recorded receivables of $106 million in its accounting records as of December 31, 1985. According to a record prepared by MARAD personnel, $54 million (50.9 percent) of those receivables was considered collectible.

Considering these bad debts on the books of the U.S. Treasury as accounts receivable, MARAD should reconsider its position and request an appropriation from Congress to liquidate the FSFF's debt to the U.S. Treasury.

Finding B. Approval of Workouts

Restructured loans (workouts) to vessel owners with Title XI loan guarantees have not been effective in aiding the maritime industry and have increased the liability of the FSFF. Management officials approved these revised loans although they were not provided pertinent information concerning available alternative actions and their related costs. We found that 11 of the 21 firms reviewed who received approvals subsequently defaulted on their loans, thereby increasing the FSFF's costs. Unless market conditions improve, seven more firms will probably default within 2 to 2 1/2 years because charter rates are not sufficient to cover operating costs and debt service. In addition, some restructuring has resulted in subordinated loans which could further increase losses to the FSFF by about $20 million. As a result, MARAD approved these restructurings wh were not in the best interest of the maritime industry and increased FSFF losses.

Discussion

A workout is a process which considers rescheduling or restructuring the terms/conditions of a loan to facilitate repayment and meet lending criteria and objectives. A workout is initiated when the original terms/conditions of a loan cannot be fulfilleloped by the debtor and must be approved by MARAD and other interested parties such as the bond trustee, lien holders, and parent corporation. The most common workout action includes the deferment of principal amortization payments for a period of 2 to 2 1/2 years and use of Title XI reserve funds to pay for Title XI debt service. Other common actions include restructuring of bond interest rates, transfers of vessels and related indebtedness, indirect loans by subordination of MARAD's prime lien position, and deferring collection of MARAD loan guarantee fees and advances.

Reason for Workout

A workout generally starts with a company being unable to generate sufficient cash to pay operating costs, debt service, and MARAD loan guarantee fees. After a company consumes its current assets to compensate for negative cash flow, attempts are made to lower cash outflow by deferring the principal portion of debt amortization payments. If interest rates are substantially higher than present market rates, a company will attempt to refinance the bond issues at lower rates. The company then is in a position of being able to avoid default until the principal amortization deferment expires, or is in need of additional cash to meet the interest portion of the debt service costs. In the latter case, the company will drawdown on its Title XI reserve funds to pay the interest costs. If the Title XI reserve has been depleted, MARAD may approve a subordinated loan, in which case MARAD surrenders first entitlement to the receipt of proceeds from the sale of defaulted vessels. Subordinations permit troubled companies to open new lines of credit. After a company has consumed its Title XI reserves and lines of credit, a default occurs on either the less profitable vessels or on its entire fleet. Throughout the process, MARAD monitors the financial status of the troubled companies and evaluates each proposed step for approval or disapproval. Approval is dependent upon protecting MARAD's interests and enabling troubled companies to survive.

Approval of Workouts

MARAD's Office of Ship Financing (OSF) evaluates workout requests using information supplied by the requesting company as well as that available from MARAD's monitoring of the company's financial position. If the OSF supports a proposed workout, an approval memorandum is prepared and forwarded to the Administrator. If the OSF does not agree with the proposed workout, no further action is taken. Generally, the memorandum only provides detailed information on the workout, and the anticipated favorable results without analysis detailing other available alternatives, and their cost impact on the FSFF.

Although MARAD personnel stated that such analyses were prepared, we found no evidence of them in the project files. We believe this procedure hampers management's ability to make informed decisions. To illustrate, a firm received a workout in early 1984 to $3.5 million without sufficient analysis in the file. According to the approval request, the firm had taken steps to reduce expenses but was still unable to meet with its Title XI obligations because of a downturn in the market. The firm projected sufficient utilization by late 1984 to provide funds to pay all costs including interest. MARAD accepted the firm's market analysis projections and recommended approval of a line of credit which also subordinated MARAD's interests. MARAD concluded that the firm would be forced to default without this assistance, thereby increasing the loss to the FSFF. In the approval of the workout request, MARAD pointed out the advantages to the Government to prevent a default such as: the market would recover by 1985; and the value of the vessel would increase as the market improves, thereby lessening the Government's risk of loss. We found no evidence that MARAD made any type of analysis using various market conditions to project the firm's potential for survival. The market conditions did not improve in 1985, as anticipated, and the firm requested and received approval to draw the remaining balance from a line of credit to pay its 1985 Title XI obligations. Based on current market conditions, this firm may default during 1986 because earnings may not be sufficient to pay debt service.

Many of the workouts reviewed involved barges or oil related vessels. The market in both of these areas is depressed which reinforces the need to document economic analyses of the various alternatives before a workout is approved.

Success of Workouts

Generally workouts have not been successful in preventing defaults. We reviewed 21 companies that obtained workouts during the 15-month period ended October 31, 1985 with outstanding guaranteed principal loan amounts totaling over $790 million. Eleven of the twenty-one companies had either defaulted, or MARAD had assumed the loan. The amount of the defaults totaled over $279 million or about 35 percent of the total guaranteed amount. An analysis of the remaining 10 companies indicated that 8 would probably default between FY 1986 and FY 1988 unless charter rates improve substantially. The two remaining companies have an opportunity to survive even under current market conditions. Most workouts were approved on the basis that vessels would have higher utilization and charter rates would increase within 6 to 12 months; however, this has not occurred. One of the reasons charter rates remained low is a decreased demand and oversupply of vessels.

Subordinated Loans

In seven workouts, MARAD subordinated its prime position to enable the companies involved to receive a line of credit. As the guarantor of Title XI loans, MARAD is entitled to retain the proceeds from sale of a defaulted vessel up to the amount of the loan and other expenses incurred in connection with repossession and/or sale. However, when MARAD's interest in the vessels is subordinated, certain rights are given up to receive funds from the sale until the lender providing funds for a workout has been paid-in-full. Subordination is not allowed by Federal credit policies contained in the Office of Management and Budget (OMB) Circular A-70. This circular states that the Government's claim on assets must not be subordinated to other lenders in case of a borrower's default on a guaranteed loan. MARAD has agreed to subordinated loans of over $19.7 million for seven companies. Four of these companies, with loans totaling about $9.4 million, have defaulted. As a result, the first $9.4 million realized from the sale of the repossessed vessels will go to the lenders rather than MARAD. Further, MARAD will unlikely realize any funds from the sale of any of the vessels because, under current market conditions, the sale price will probably be well below the value of the outstanding loans. If the remaining subordinated loans are defaulted, potential losses to the FSFF will total about $20 million.

In conclusion, workouts have not benefited the maritime industry, but rather have increased the liability of the FSFF. Eleven of the companies receiving workouts have either defaulted or had MARAD assume their loans. Another eight companies will probably default unless market conditions improve dramatically. Workouts temporarily improve the ability of a particular firm to operate longer by reducing the need for cash. Many workouts may have been counterproductive because less efficient companies continue to compete at lower charter rates since debt service has been decreased or suspended. Also, reduction of charter rates for a particular segment of the industry may have caused other companies to experience additional financial problems.

Recommendations

We recommend that MARAD:

1. Document cost analyses for workouts. These analyses should include the potential cost to the FSFF, considering various alternatives and market conditions, and be included as part of the request for approval.

2. Cease approving workouts in those cases which MARAD subordinates its first position to participate in the proceeds from the sale of defaulted assets.

Management Comments

MARAD officials did not agree with the recommendations. They stated that the cost to the FSFF of appropriate alternatives for workouts is reviewed; annual market studies are made and updated, as appropriate, at the time of a workout; and the anticipated market condition is set forth in the request for approval. In addition, workouts decrease the liability of the FSFF because the accrued interest on a defaulted loan is less since the workout is implemented prior to the defaulting payment. Also, no subordinated agreements have been approved subsequent to the issuance of OMB Circular A-70 (August 24, 1984) which prohibits the subordination of the Government's claims on assets when borrowers default on direct or guaranteed loans. (The entire response is provided as an Appendix to this report.)

Audit Comments

Workout assistance provided to financially troubled companies does in some instances lower the interest payable upon default. Further, workouts enable an unprofitable company to continue operations, deplete assets and increase the default loss, prolong the vessel oversupply market condition, and may lower the rates that the more successful marine operators are able to charge. Our review of 14 requests for workout approvals showed that 11 provided only standard boiler plate language in the alternatives section while the remaining 3 requests had no alternatives section. The alternative section included in the request generally stated that unless the workout is approved, the firm will default. When Maritime Aid officials decide to support a workout request, the request ignores the worst case situations and the financial implications. Market studies, when used, are optimistic such as projecting rate increases in a depressed market. MARAD should assure that all information generated by cost analyses for workouts is considered when determining whether to approve the workouts.

Although we did not find any subordinated loans approved after OMB's prohibition, we do not consider the earlier subordinations acceptable loan management practices. In addition, MARAD has permitted five marine operators to draw down $5.6 million on previously approved subordinated lines of credit subsequent to OMB's prohibition. This action violates the intent of OMB's guidance and, in effect, further subordinated the Government's interest. MARAD should discontinue approval of such drawdowns.

Finding C. Title XI Obligations for LNG Tankers Conversion

MARAD used insurance proceeds to convert two LNG tankers to dry bulk carriers rather than sell or scrap the vessels and liquidate the Title XI debt. Although the project received high level approval, the vessels were unsuitable for the intended trades because of their unusual configuration. Therefore, the use of these vessels would not generate sufficient earnings to justify the financial risk involved. Revenues would be further affected by the lack of cargoes on a regular basis in large enough lot sizes to permit profitable employment of the vessels. The project ultimately proved to be unsuccessful, as anticipated by the management and program officials, and resulted in default of the Title XI guaranteed loans. In order to honor its guarantees, MARAD had to borrow an additional $75 million from the Treasury since the insurance proceeds were used for ship conversion purposes.

Discussion

In 1975, MARAD guaranteed Title XI obligations of the El Paso Company for the construction of six LNG tankers. At that time, El Paso anticipated a continuing market for liquefied natural gas and it had a long-term transportation agreement with the Government of Algeria. Three of the vessels (Arzew, Gamma, and Southern) were built at the Newport News Shipyard, and required over $207 million in Title XI guarantees. The remaining vessels (Columbia, Savannah, and Cove Point) were built at the Avondale Shipyard and required over $249 million in Title XI guarantees.

The Newport News vessels were delivered between March 1978 and June 1979 and used in the LNG trade until about April 1980 when they were laid up because of disputes with the Algerian Government over LNG prices. The Avondale vessels, however, were never placed in service because they had faulty container systems.

Conversion to Bulk Carriers

The Avondale vessels were insured against faulty construction. As a result of the problems with the vessels' container systems, they were unusable and El Paso filed an insurance claim which was settled in September 1980 for $300 million to be paid over 3 years. The company received $90 million and established a $210 million security fund to defray layup and debt service costs for the vessels. At that time, El Paso and MARAD agreed to sell or scrap the vessels and provide MARAD with funds necessary to meet any shortfall Title XI debt for the three vessels.

Instead of disposing of the three vessels as planned, the El Paso Company and MARAD agreed to convert them into dry bulk carriers and then sell them. However, while enroute to a layup site, one vessel (Columbia) went aground and was dropped from the conversion project. A separate $90 million fund was established for the Columbia to defray layup expenses and debt service ($70 million from the security fund and $20 million from insurance proceeds from the grounding). The remaining $140 million in the security fund was used to convert the other two vessels to dry bulk carriers, and to defray towing costs and debt service. The converted vessels were purchased by the Phoenix Companies for about $214 million.

The decision was made by MARAD, with the advise of its Chief Counsel, to permit the use of insurance proceeds to meet debt service, layup costs, and convert the two vessels to bulk carriers without full concurrence of key management and program officials. They recognized the risks with the conversion project which indicated marginal economic soundness. Some of these risks included insufficient charter revenues to sustain operations, limited port/terminal accessibility due to the size of the vessels, marginally acceptable vessel maneuverability, potential structural deficiencies, and shortfalls in anticipated interest income from the security fund needed to supplement operating revenues. Between the conditional approval of the project and final approval, financial support for the project changed and the degree of risk increased. Although aware of the increased risks due to a significant change in the equity lease and reduction of interest income, MARAD granted final approval for the conversion project in February 1982. Of the $140 million of insurance proceeds associated with the two Phoenix vessels, about $63 million was expended for debt service and guarantee fees, $13 million was used to make the vessels ready for transport to the conversion shipyard, and the remaining $64 million for conversion.

The project proved to be uneconomical. After conversion in 1983, the use of these vessels had significantly been reduced. By 1984, MARAD had advanced the Phoenix Companies about $9 million to meet debt service because revenues were not sufficient to meet costs. In 1985, the vessels were laid up in a foreign port and the Phoenix Companies defaulted on the Title XI obligations. In May 1985, MARAD paid $135 million to satisfy the Title XI debt. As a result of this project, MARAD had to borrow more than $75 million from the Treasury to cover conversion and towing costs in excess of available insurance proceeds, thereby increasing its liability of the FSFF. Under the terms of the 1980 insurance settlement agreement, El Paso Company had an obligation to reduce MARAD's liability for the Title XI debt. However, with the approval of this high risk conversion project, MARAD released El Paso from its obligation.

MARAD approved the conversion of the Avondale vessels to enhance the dry bulk shipping industry and at the same time decrease the exposure to the Title XI fund. However, neither goal was achieved because sufficient cargo was not available to generate enough revenues to meet debt service. We believe that the three vessels should have been sold or scrapped and the proceeds used to liquidate the Title XI debt. Such action would have reduced MARAD's borrowings from the Treasury by $75 million with a corresponding reduction in the liability to the FSFF.

Recommendations

We recommend that MARAD:

1. Establish and implement a policy requiring periodic preparation of cost/benefit analyses to evaluate projects for which MARAD has assumed control of the vessels.

2. Use the cost/benefit analyses as the basis for evaluating the action to be taken.

Management Comments

MARAD officials stated that the original settlement agreement provided for the potential sale of the vessels as well as for scrapping them. The risk of converting the vessels into bulk carriers to modernize the American flag bulker fleet was recognized. The project failed because the anticipated coal boom did not materialize. MARAD also maintains that cost/benefit analyses are prepared and utilized during the life of a project. (The entire response is provided as an Appendix to this report.)

Audit Comments

We found only two cost/benefit analyses in MARAD's files. Both were prepared prior to the vessel conversion and indicated marginal economic soundness. One analysis recommended finding alternative employment for the vessels while the other concluded that the project would only be successful if operating revenues were supplemented by other income. The decision was made to approve the project with the clear understanding of the conclusions from the analyses. To properly evaluate projects with an extended life, and to enable managers to make informed decisions, we believe that MARAD should periodically prepare and update cost/benefit analyses for these projects.

Finding D. Formation of GEN Marine Company

MARAD had a company formed to purchase four LNG tankers owned by subsidiaries of the El Paso Company. This action was taken without sufficient analyses or consideration of such other alternatives as default or direct assumption of the Title XI debt. Formation of the company resulted in unnecessarily increasing the FSFF costs by about $1 million for legal, accounting and administrative fees, and taxes which otherwise would not have been incurred.

Discussion

In 1975, MARAD guaranteed Title XI loans for the construction of LNG tankers for subsidiaries of the El Paso Company. Three tankers (Arzew, Gamma, and Southern) were built at the Newport News Shipyard and received over $207 million in Title XI guaranteed loans. These vessels were used in the LNG trade until about April 1980 when they were laid up because of a price dispute with the supplier. A fourth vessel (Columbia) built in the Avondale Shipyard, went aground prior to planned conversion to a dry bulk carrier and was dropped from that project.

Corporation Created to Purchase LNG Vessels

The El Paso Company advised MARAD in October 1981 that by September 30, 1982, the three LNG subsidiary companies would not have sufficient funds to meet further debt service and layup expenses. When attempts to find a buyer failed, a corporation was created to purchase the LNG vessels. In June 1983, MARAD contracted with the U.S. Corporation Company to form GEN Marine Company. For $1.00, GEN Marine purchased the stock of the three El Paso Company subsidiaries that owned the Newport News Vessels. Also for $1.00, GEN Marine purchased the stock of the Columbia Tanker Company. The Columbia tanker was not suitable for LNG trade and had received insurance proceeds ($70 million) for construction deficiencies. Another $20 million was received in insurance proceeds when the vessel went aground.

GEN Marine Company, a legal fiction, had no capital to meet operating expenses and could not generate income for vessel operations. Funds to meet GEN Marine costs and Title XI obligations of the tanker companies were transferred from the Columbia Fund ($90 million) to either GEN Marine Company or one of the tanker companies who in turn paid creditors. All fund transfers and payments were directed by MARAD.

We believe that the formation of GEN Marine Company was not cost-effective. GEN Marine and/or the tanker companies have incurred about $1 million in legal and accounting fees, corporate franchise taxes, property taxes on the vessels, and administrative fees which would not have been incurred had MARAD assumed the debt or placed the vessels with an owner/trustee. MARAD could eliminate such recurring costs as legal fees and property taxes of more than $300,000 annually, by dissolving GEN Marine Company.

At the time the GEN Marine Company was formed, the Columbia fund supported itself as well as the three other subsidiary companies. We found no evidence however, that MARAD prepared any feasibility studies prior to forming GEN Marine Company, or at other intervals while the Columbia fund was being depleted, to determine whether this was the most cost-effective approach. Such studies would have provided information to determine if a default or other approach, such as assuming the debt, would have been more cost-effective. According to MARAD personnel, the bondholders would not agree to an assumption of the bonds by MARAD because of their low interest rates. However, we found no evidence that the bondholders were contacted to determine if they would agree to an assumption. As a result of forming GEN Marine Company, MARAD had to borrow over $60 million in 1985 to pay the Title XI debt on the Columbia. The $90 million in insurance proceeds would have been more than enough to pay the Title XI debt.

Recommendations

We recommend that MARAD:

1. Dissolve the GEN Marine Company and place the vessels under an owner/trustee to realize annual savings of more than $300,000 in recurring accounting fees and property taxes.
2. Perform a cost/benefit analysis and determine whether to (a) default on the three loans guaranteed from the Newport News vessels or (b) assume the applicable Title XI debt.
3. Establish and implement a policy requiring periodic preparation of cost/benefit analyses to evaluate projects for which MARAD has assumed control of the vessels.

Management Comments

MARAD officials stated that the expenses incurred with GEN Marine were initially justified by the savings in interest expense and that GEN Marine is being dissolved. The loans on the Newport News vessels were paid off on May 7, 1986. The decision to default on the loan was made in April 1986 based on the Treasury interest rate for the month of May. The response also indicates that MARAD does perform cost/benefit analyses. (The entire response is provided as an Appendix to this report.)

Audit Comments

MARAD's actions in dissolving GEN Marine and determining the need for and causing a default on the three loans satisfy the intent of our first two recommendations. Our recommendation to perform cost/benefit analyses refers to the need to perform comprehensive, well documented studies and to objectively analyze them. Although MARAD maintains that cost-benefit analyses are made, we found no evidence of such analyses in MARAD's files to enable management to determine the appropriate action to take concerning GEN Marine. We believe that MARAD should periodically prepare and update cost/benefit analyses to facilitate evaluation of projects and enable managers to make informed decisions.

Finding E. Articulated Tug/Barge Project

Progress payments made to a shipbuilder for two barges were excessive. They were based on inaccurate percentages of completion and were in excess of work accomplished and materials received. These overpayments, at one point, totaled $4.1 million which was later resolved through the discontinuance of progress payments for a 9-month period on a settlement agreement.

Excessive Payments. During construction of the two barges (Numbers 34 and 35) MARAD made progress payments to Manhattan Barge I, Inc., based on a percentage of completion for each barge. MARAD made a decision to complete one of the barges, although results of independent market surveys indicated that the decision was not financially sound. The surveys showed a lower market value for the barge than anticipated by MARAD and that a buyer was not available for that type vessel. The work to complete the barge cost MARAD about $5 million without any known benefit. The percent[illegible] represented the weighted average of the materials purchased [illegible] the amount of labor expended. Payments for Barge No. 34 totaled $7.8 million based on 94.6 percent completion, and $7.3 million for Barge No. 35 based on 87.2 percent completion. The Office of Ship Construction revised these percentages of completion downward on the two barges, as follows:

	From	To
Barge No. 34	94.6%	84.5%
Barge No. 35	87.2%	68.8%

The payments to Manhattan Barge I, Inc., were approved in excess of materials received and work accomplished by an onsite construction representative assigned by MARAD to monitor and certify the company's billings. At the time the percentages were revised, excessive progress payments totaled approximately $4.1 million. Due to the financial condition of the shipbuilder at the time of these changes, the overpayments could not be refunded. To help rectify the situation, MARAD ceased making payments for a 9-month period. A contract settlement agreement increased the contract cost by about $5 million, further assisting in correcting the overpayment situation. However, the actual cost to complete Barge No. 34 ($10 million excluding rework costs) and the estimated costs to complete Barge No. 35 (between $12 and $17 million) further indicates that the completion percentages certified for payment were overstated.

Because of the inaccurate percentages of completion used to calculate progress payments, MARAD needs to establish policy that would include key event schedules to complement the point system and have different inspectors certify percentage of completion throughout the life of the contract. Further, when the shipbuilder and the shipowner are affiliated, MARAD should place greater emphasis on monitoring payments and certification of shipowner equity contribution.

Decision to Complete Barge. Coordinated Caribbean Transport, Inc. notified MARAD that the shipyard was in default because Barge No. 34 had not been delivered on schedule and, in accordance with the terms of the contract, the barge was subject to nonacceptance. This left MARAD with a decision to either complete the barge or sell it for scrap. MARAD decided to complete construction of the barge at an additional cost of $5 million.

Although this decision was based on MARAD's projected expected sale of the vessel for about $23 million, a buyer was not available at the time. Results of independent market surveys provided to MARAD indicate that a completed tug/barge unit had a market value of about $14 million.

However, there also was no ready buyer for this type of vessel. As a result, after all other parties to the contract were relieved of their obligations, no benefit was received by the Federal Government for providing an additional $5 million to complete the barge. A buyer could not be found for the barge and its mating tug unit for several years. The unit was sold for about $7.5 million.

Recommendations

We recommend that MARAD:

1. Establish and implement procedures to verify progress payments to financially troubled shipbuilders. These procedures should consider rotating inspectors and using a schedule of key events during construction to verify the progress.
2. Consider all available data, such as market studies, in-house evaluations, market conditions, etc., prior to committing project funds.

Management Comments

MARAD officials generally agreed with the finding but nonconcurred with the recommendations. They maintain that the incidence of excessive progress payments is rare and this particular incident represents an isolated case. In addition, MARAD contends that the completion of the barge was justified by the appraisals which showed that MARAD could reasonably expect to recover the completion costs through subsequent sale of the tug/barge unit. (The entire response is provided as an Appendix of this report.)

Audit Comments

The incidents of excessive progress payments cited is not isolated. We found in other reviews (Tractug vessels and incinerator ships) that excessive progress payments have been made, especially when the vessels were being built at a shipyard having financial problems. These incidents indicate a need for increased emphasis on monitoring progress payments by rotating inspectors and using key event

schedules to evaluate construction progress. MARAD requested two market surveys by independent firms to determine demand and value of the tug/barge unit. These surveys emphasized the lack of an available buyer for the unit. The lack of interest was due primarily to restrictions on the unit's use because of Construction Differential Subsidy financing. About 2 years after completion of the barge, MARAD sold the unit for $7.5 million to an under-capitalized company, which MARAD identified as having unrealistically large revenue expectations. The purchaser defaulted and MARAD again became the owner of the tub/barge. A more conservative approach and greater sensitivity to available data, as set forth in our recommendations would have prevented MARAD from financing the completion of the barge.

Finding F. Managing Defaulted Vessels

MARAD has not made a cost comparison to determine the most economical location to store defaulted vessels. Annual storage costs of approximately $3.8 million was incurred for these vessels and insurance costs of about $500,000 annually was paid. We estimate that savings of as much as $1.3 million annually, could be realized by using National Defense Reserve Fleet (NDRF) sites to store the defaulted vessels. In addition, the insurance maintained for them can be dropped for an additional annual savings of $500,000.

Discussion

When defaults occur, MARAD honors the guarantee and generally takes possession of the vessels. Vessels are retained for sale: (1) to maritime companies, (2) for alternative uses, or (3) as scrap. MARAD's practice is to hold defaulted vessels for disposition at contractor operated layup sites. In FY 1985, MARAD paid about $3.8 million for contractor layup and over $500,000 for insurance on the acquired vessels.

Layup Practices

MARAD policy provides for reasonable contractual layup costs consistent with the protection and preservation of the Government's interest. The FSFF pays for annual vessel custodial contracts at costs ranging between $23,000 for "simple moorage" (custodial services only, without maintaining the machinery or power plants in ready-to-operate condition) and over $100,000 for MARAD's preferred "maximum resale" condition (ready to sail within 30 days).

MARAD also maintains an NDRF of merchant vessels at anchorage sites at James River, VA; Beaumont, TX; and Suisun Bay, CA. These sites are strategically located near major ports used by the merchant marine industry, and are geographically located near contractor layup sites. NDRF vessels are stored in two broad categories of readiness. The majority of moored vessels receive minimal care ("simple moorage" layup condition) and are available for resale or scrapping. A preselected number of vessels are preserved for reactivation if needed during a national emergency and could be placed in operation on a 10-day notice. These vessels are maintained in a preferred status ("maximum resale" condition).

Although MARAD maintains vessels in the same conditions as do contractors, we found no evidence of comparisons of the cost to maintain them at contractor layup sites for the majority of vessels in MARAD's possession with those of the NDRF. We were unable to compare layup costs of the NDRF with those at contractor sites because of dissimilarities in the types of vessels maintained. However, in one case, we found that the cost to maintain two cargo ships at a contractor's site in simple custodial moorage exceeded the average NDRF simple moorage costs by over $75,000 annually. Using this example, we compared total annual contractor storage costs for all types of vessels with similar costs at the NDRF. The comparison showed that the cost to MARAD to use the contractor's facilities exceeded those of the NDRF by as much as $1.3 million. Because MARAD procedures do not require developing NDRF layup costs as a competitive alternative to contractor storage, MARAD managers could not make decisions ensuring the most economical storage of defaulted vessels. MARAD contractual storage may be unnecessarily draining the FSFF.

We recognize that in certain instances these may be benefits to maintaining vessels at contractor sites even if costs are higher. However, a periodic cost comparison should be made to determine at what point vessels should be transferred from a contractor site to the NDRF.

Insurance Practices

MARAD policy requires current market value Hull Protection and Indemnity Insurance coverage on all vessels acquired by default. In FY 1985, such insurance cost the FSFF over $500,000. The coverage is maintained even though an industrywide market analysis shows that the laid up vessels have limited, if any, resale value due to changing industrywide needs and an overbuilt merchant marine fleet. Further, the Federal Government normally self-insures assets including vessels in the NDRF. With a limited resale market, commercial marine insurance becomes a long-term cost drain on the FSFF. Self-insurance on defaulted vessels could reduce the costs to the FSFF.

In summary, past practices appear to have been based on management assumptions which included an optimistic resale market. However, the number of recent and anticipated future defaults place the fund in a position which requires a very cost-conscious management approach. The worsening market situation for the overbuilt merchant marine industry should also foster a prudent and cost-effective management approach. Furthermore, ample room exists at MARAD NDRF sites to store the defaulted vessels. Therefore, procedures which emphasize cost-conscious evaluations of: (1) current market conditions, (2) Government anchorage versus contractor layup, and (3) the need to insure vessels with a limited resale potential should be developed to ensure that current and future management decisions are cost-effective.

Recommendations

We recommend that MARAD:

1. Develop and implement procedures requiring cost comparisons to determine the most economical location to store defaulted vessels.

2. Eliminate commercial insurance for defaulted vessels.

Management Comments

MARAD officials stated that storage costs for defaulted vessels have been compared to ensure the most economical sites are used. MARAD maintains that storage at NDRF would be more expensive than private custodial care because of dehumidification and immediate reactivation condition requirements. MARAD partially agreed with the recommendation to eliminate commercial insurance for defaulted vessels, but stated that the auditors did not fully address marine insurance coverages, such as hull and machinery insurance. The response also indicates that MARAD has developed guidelines for marine insurance coverage. (The entire response is provided as an Appendix to this report.)

Audit Comments

The NDRF has and will continue to store Title XI defaulted vessels under owner specifications. While dehumidification and water drainage services prolong a vessel's life, such services are not a fleet storage requirement. MARAD has, in the week ended June 14, 1986, stored two Title XI defaulted offshore tugs at the Beaumont, TX NDRF facility at an approximate savings of $900 per month per vessel. Eight additional vessels are scheduled for storage at Beaumont. Annual savings for the 10 vessels should approximate $108,000. There are approximately 50 more vessels in the Gulf area which, if bankruptcy problems are resolved and MARAD obtains possession, could be more economically stored at Beaumont, TX.

At the time the audit was performed, MARAD had no written marine insurance policy. Subsequently, we learned that MARAD has prepared a draft study on self-insurance which included such coverages as Hull and Machinery, Protection and Indemnity, and War Risk.

The action MARAD has taken or planned concerning vessel storage and self-insurance will satisfy the intent of our recommendations.

IV. BACKGROUND

The Federal Ship Financing Guarantee Program was established by Title XI of the Merchant Marine Act of 1936, as amended. The program allows the Federal Government to insure (guarantee) private sector loans to promote the growth and modernization of the U.S. flag merchant fleet, and to encourage private sector use of domestic shipbuilding facilities. The Title XI program was established to permit construction of merchant ships without the need for direct Government loans. Participants in the program are charged a one-time investigation fee and an annual guarantee fee. These fees, along with interest income, repayments of advances, and proceeds from the sale and charter of ships acquired as the result of defaults, are deposited in the FSFF. The FSFF is a revolving fund from which the program's operating expenses are paid and, in the event of a default, the guarantee is honored. MARAD has guaranteed about $7.5 billion in loans under the program. Recently, large defaults have depleted the FSFF and, to honor guarantees, MARAD has borrowed from the Treasury over $450 million as of December 1985. Additional borrowing will be necessary to honor guarantees as other defaults occur.

APPENDIX

Memorandum

U.S. Department
of Transportation
**Maritime
Administration**

Subject Draft Report on the Management of the Federal Ship Financing Program

Date June 4, 1986

From James G Zok
James G. Zok
Deputy Associate Administrator
for Maritime Aids

Reply to Attn of KURYLO:2-0395

To
Wilbur L. Daniels, Acting Director
Office of Aviation, Marine and Research Program

This is in response to the Draft Report transmitted by memorandum dated April 21, 1986. The following is a section by section response to each finding and recommendation:

Finding A - Status of Federal Ship Financing Fund

The FSFF has had to borrow from the Treasury to meet the large number of recent defaults. MARAD should not continue to borrow from the Treasury to pay off defaults, rather it should request a write-down of this debt immediately.

MARAD Response

We disagree with this finding and consider that the best course of action is a one-time write-down after the current surge of defaults has occurred. After this single write-down, MARAD can again be self-supporting with respect to Title XI. This appears to be the preferable method from the standpoint of MARAD, Treasury, and the Congress. We disagree with the assertion that 50% of advances are uncollectible. MARAD has not written off these advances as uncollectible and will pursue every avenue to realize collection on these advances. We disagree with the assertion that opportunities to sell defaulted vessels are unlikely. Upon foreclosure, we can and have sold vessels, albeit for less than the pay-off amount.

Recommendation 1

We recommend that the Director, Office of Ship Financing request an appropriation from Congress to liquidate the debt owed to the Treasury by the FSFF.

Recommendation 2

We recommend that the Director, Office of Ship Financing make annual projections of FSFF revenues and expenses and request appropriations for any anticipated shortfalls.

MARAD Response

The proposals to make an immediate request to write-off the current Treasury debt owed by the FSFF and annual appropriations thereafter neglect the timing of the future default situation. We do anticipate substantial defaults in the near term. To write off existing debt now would accomplish nothing other than necessitating another borrowing in the near future. The best method is to wait until the bulk of defaults have passed and then make one single request for a write-off. Thereafter it is hoped Title XI will return to the self-supporting status it held until recently. There is no need to institutionalize annual write-offs. We anticipate only one will be needed after the current surge of defaults has subsided.

Finding B - Approval of Workouts

Finding

Restructuring of loans (workouts) has not been effective in aiding the maritime industry and has increased the liability of the FSFF.

MARAD Response

OMB Circular A-129 (May 9, 1985) prescribes the standards for debt rescheduling. The Circular prescribes that agencies shall permit rescheduling of payments only when it is in the best interest of the Government and where the Agency has determined that ~~recovery~~ of all or a portion of the amount owed is reasonably assured. The recommendations approved by MARAD make this determination for workouts approved subsequent to the issuance of the Circular. MARAD will continue to document in the written recommendation the cost analysis for the workout. It should be noted that there is not a direct cost to a principal deferral and, therefore, no additional cost to the FSFF.

The draft report incorrectly states that workouts have increased the liability of the FSFF. Workouts, defined as restructuring of loans with lower interest rates, and principal deferrals do *not* increase the liability of the FSFF when compared to an immediate default. In fact, such workouts *decrease* the liability of the FSFF as the accrued interest in the event of default is less if the workout is implemented prior to the defaulting payment.

Recommendation 1

Document cost analyses for workouts. These analyses should include the potential cost to the FSFF considering various alternatives and market conditions and be included as part of the request for approval.

MARAD Response:

It is our existing practice to review the cost to the FSFF of appropriate alternatives for any recommended workout. The various alternatives are included as part of the written recommendation for approval. Market studies are conducted on an annual basis for various market sectors such as drill rigs and inland barges. These studies are supplemented by additional updated analyses as appropriate at the time workout actions are reviewed. Market conditions are reviewed in detail and summarized in the recommendation. The anticipated market condition is set forth and must support the recommended action.

Recommendation 2

Cease approving workouts in those cases which MARAD subordinates its first position to participate in the proceeds from the sale of defaulted assets.

MARAD Response

OMB Circular A-70 (Revised) (August 24, 1984) established guidelines for managing Federal credit programs. The Circular includes a statement that the Government's claims on assets must not be subordinated to other lenders in the case of a borrower's default on either a direct loan or a guaranteed loan. MARAD has approved *no* subordinated agreements (Intercreditor Agreements) subsequent to the issuance of OMB Circular A-70 (Revised) on August 24, 1984. All the subordinated loans referenced in the

I.G. Report were approved prior to the issuance of the revised circular, and were based on analysis which demonstrated that these transactions were proper based on the situation at the time. We believe the recommendation and t's attendant discussion are unnecessary and should be deleted as not relevant to existing MARAD practices.

Finding C - Title XI Obligations for LNG Tankers Conversion

MARAD used insurance proceeds to convert two LNG tankers to dry bulk carriers rather than sell or scrap the vessels and liquidate the Title XI debt. Even though there were significant risks inherent in the project MARAD went ahead and the project ultimately proved unsuccessful causing MARAD to borrow an additional $75 million from Treasury.

MARAD Response

The original settlement agreement did provide for the potential sale of the vessels as well as a scrapping scenario. The project did have risks but the projected benefits in terms of modernizing the American flag bulker fleet were significant. Although conversion costs and start up expenses were higher than projected, the principal reason the project failed was because the projected coal boom which was to provide the primary employment for the vessels did not materialize. At that point in time coal colliers were waiting at U.S. loading ports for significant periods to pick-up their cargoes. When this coal trade did not develop as projected, the ships had to find employment in other trades. As world freight rates had declined to extremely low levels, the primary area in which the vessels traded was PL-480 cargoes. The stiff competition in this trade only permitted Phoenix to generate revenues at or slightly above operating costs. As a result the safety margin built into the project (i.e. monies in the Security Fund) was quickly dissipated. In spite of these factors the project did achieve certain of the anticipated benefits. The primary benefit realized was the reduction of freight rates in the PL-480 trades. It has been estimated that the introduction of the Phoenix vessels in this trade reduced rates by approximately $10/ton. This reduction saved the Department of Agriculture tens of millions of dollars.

Recommendations

1. Establish and implement a policy requiring periodic preparation of cost/benefit analyses to evaluate projects for which MARAD has assumed control of the vessels.

2. In the absence of overwhelming evidence to the contrary, the results of these analyses should be used as the basis for determining the action to take on each project.

MARAD Response

1. & 2. MARAD has and will continue to perform cost/benefit analyses in the evaluation process. The results of these analyses will continue to form the basis for determining the course of action MARAD will pursue.

Finding D - Formation of GEN Marine

Findings

MARAD's formation of GEN Marine to purchase the stock of four LNG companies was done without sufficient analysis of the alternatives and resulted in MARAD incurring unnecessary expenses of approximately $1 million.

MARAD Response

GEN was formed as a mechanism to maintain the existing Title XI debt. At the time of GEN's formation the interest rate on GEN's Title XI bonds was below the prevailing interest rate. This interest rate differential, which continued until just recently, was used to the Government's advantage and resulted in substantial interest savings. The bonds did not provide for MARAD's direct assumption of the indebtedness. It was determined that MARAD should not be the obligor and guarantor of the indebtedness. Therefore, GEN was created. Although certain costs were incurred in the formation of GEN, most of GEN's expenditures would have been incurred in any event. Any additional expenditures that were incurred were more than offset by the interest savings resulting from maintaining the bonds.

Recommendations

1. Dissolve the GEN Marine Company and place the vessels under an owner/trustee to realize annual savings of more than $300,000 in recurring accounting fees and property taxes.

2. Perform a cost/benefit analysis and determine whether to (a) default on the three loans guaranteed from the Newport News vessels, or (b) assume the applicable Title XI debt.

3. Establish and implement a policy requiring periodic preparation of cost/benefit analyses to evaluate projects for which MARAD has assumed control of the vessels.

MARAD Response

1. MARAD has authorized the dissolution of the GEN companies. Dissolution is anticipated to occur in the near future.

2. Based on MARAD's borrowing cost from the Treasury for the month of May of 7 3/8%, MARAD determined that maintaining the existing Title XI indebtedness at approximately 8 1/2% was no longer appropriate. Therefore, when the payment came due, April 1, 1986, no funding was provided by MARAD to make this payment. This resulted in the Indenture Trustee demanding on the Title XI guarantee at the end of the 30 day grace period. MARAD paid off the bonds on May 7, 1986.

3. MARAD has and will continue to perform cost benefit analyses in analyzing projects.

Finding E - Articulated Tug/Barge Project

The I.G. has determined that the shipbuilder received construction payments in excess of the percentage completion and that MARAD decided to complete the vessel even though an independent appraisal indicated that the decision was not sound.

MARAD Response

The contract for the construction of these vessels was executed in 1975. The overpayments, our corrective action, and subsequent review of the entire issue took place in the last decade.

The I.G. is correct in their first assertion that payments in excess of completion were made. When discovered, MARAD rectified the situation by withholding future payments. This type of situation is rare and the incidence of this event is extremely low when compared to the number and dollar volume of contracts administered by MARAD under the present system. We do not believe this isolated case indicates a need for revision.

The I.G.'s finding is misleading with respect to the second issue. Although an independent appraisal indicated a lesser market value than MARAD's appraisal, appraising is an inexact science and appraisers often disagree by significant amounts. For instance in the supply boat market, MARAD has received independent appraisals where one is 50% of the other.

Furthermore, the independent appraisal showed a value of $14 million versus an estimated completion cost of $5 million. Since the I.G. did not address the issue, the report is silent on whether MARAD in fact would fully recover the $5 million even if the vessel was sold for only $14 million. The I.G. implies because there were differences in the appraised value, the decision to complete was not sound. The I.G. fails to address, however, whether MARAD could reasonably expect to recover the additional expected costs of completion. That is the more pertinent question.

Recommendations

1. Better monitor progress payments to financially troubled shipyards; consider rotating inspectors; and use a schedule of key events.

2. Consider all relevant data prior to committing funds to projects.

MARAD Response

1. As indicated above, we believe the present system of disbursing escrow accounts is appropriate. Before approving construction period financing, a financial analysis of the yard is performed. Depending on this analysis, measures (i.e. performance bonds, mortgage period financing, etc.) are implemented for shipbuilders where financial difficulties are identified. We do not believe the rotation of inspectors is necessary. The underlying assumption by the I.G. is that familiarity with the yard clouds the inspectors' judgment. The experience of the appointed construction representative in ship construction methods, building operations and schedules, and material flow throughout a facility along with the integrity of the individual inspector contributes to the proper monitoring of the project and physical progress certification. By not rotating inspectors, the Agency maintains a consistent basis for making progress approvals. The individual inspector's experience, knowledge and judgment are paramount to rendering an appropriate evaluation of the project. We also believe the percentage completion method is better than a key events schedule. It is more comprehensive, recognizes expenditures for material and labor and is more closely aligned to the actual physical construction of the vessel. The key events schedule is a necessity to the owner only in that detailed cost estimates are generally not available to a purchaser and some "timetable" must be developed to smooth out the payment schedule.

2. We do consider all relevant data before committing funds to a project. It is always easier to recognize mistakes after the fact than to project them.

Finding F - Managing Defaulted Vessels

Lay-up Practices

MARAD has not made cost comparisons to determine the most economic location to store defaulted vessels. Savings of as much as $1.3 million annually could be realized by using NDRF sites to store defaulted vessels.

MARAD Response

MARAD has made extensive cost comparisons regarding the lowest cost custodians to store defaulted vessels and will continue this practice in the future so as to ensure the lowest costs possible.

In general, these comparisons have resulted in a determination that using the NDRF to store defaulted vessels would not save any money. The NDRF exists to provide surge merchant marine lift capacity in the event of national emergency. The NDRF staff and procedures are organized to provide maximum readiness maintenance to military mission cargo vessels. The maintenance provided by the NDRF includes dehumidification and other service necessary to maintain cargo vessels for immediate reactivation. This mode of operation by its very nature is more expensive than more passive, but still commercially sound, private custodial care more appropriate for tug/supply vessels, barges, etc. MARAD has used the Reserve Fleet for defaulted cargo liners, however our current inventory of defaulted vessels makes private custodial care more cost-effective. However, we will continue to evaluate the economic viability of using the NDRF in the future.

Recommendation I

We recommend that the Associate Administrator for Maritime Aid develop and implement procedures requiring cost comparisons to determine the most economical location to store defaulted vessels.

MARAD Response

See comments under Finding F., above.

Recommendation

2. Eliminate commercial insurance for defaulted vessels.

MARAD Response

MARAD concurs only to a limited extent with this recommendation. The I.G. Report does not fully address marine insurance coverages which include Hull and Machinery Insurance, Protection and Indemnity Insurance and War Risk Insurance. MARAD has developed guidelines for marine insurance coverage.

Summary and Conclusion

A review of the recommendations in the draft IG report reveals that in all cases either (1) MARAD has been taking the recommended action prior to this IG review or (2) we disagree with the recommendations for the reasons stated herein. Therefore, we see no need for any corrective action as a result of this draft IG report. We recommend that the final report be revised to incorporate the comments presented herein and to make deletions where appropriate.

GAO United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-226298

August 28, 1987

The Honorable Glenn M. Anderson
Acting Chairman, Subcommittee on
Merchant Marine
Committee on Merchant Marine
and Fisheries
House of Representatives

Dear Mr. Chairman:

This report, prepared in response to the former chairman's December 20, 1985, request, discusses the Maritime Administration's efforts to improve data on its Federal Ship Financing Program and Fund. The report identifies the portion of the program's portfolio that is considered to be at risk of default, the financial condition of the fund, and internal control weaknesses in program data. It also covers whether the fund's financial statements properly recognize potential future default payoffs on the outstanding portion of the program's portfolio and whether the estimates of potential future default payoffs are reasonable. Program officials generally have taken or plan to take action to address the problems we noted.

We are sending copies of this report to the Secretary of Transportation and the Administrator, Maritime Administration. We will also make copies available to others upon request.

This work was performed under the direction of Mr. Kenneth M. Mead, Associate Director. Other major contributors are listed in appendix II.

Sincerely yours,

J. Dexter Peach

J. Dexter Peach
Assistant Comptroller General

Executive Summary

Purpose

In a letter expressing concern about the mounting default payments in the Maritime Administration's (Marad) federal ship financing program, the Chairman, Subcommittee on Merchant Marine, House Committee on Merchant Marine and Fisheries, asked GAO to answer five questions about the program and its approximately $5 billion portfolio of loan guarantees as of September 1986: (1) What portion of companies with loan guarantees is considered to be at risk of default? (2) What is the financial condition of the fund that finances the program? (3) Does Marad maintain reliable data on the program's loan guarantees and companies at risk of default? (4) Do the fund's financial statements properly recognize potential defaults on outstanding loan guarantees? (5) How accurate are Marad's estimates of expected defaults?

Background

The loan guarantee portion of the program was established in 1972 to encourage the construction of vessels in the United States. With Marad's approval, a U.S. citizen shipowner obtains a loan guaranteed by the United States from a bank or other private sector lender.

The fund that underwrites the program receives income primarily from statutory fees set by Marad and paid by shipowners whose loans are guaranteed and pays the program's expenses, including defaults. Marad has authority to borrow from the Treasury when the fund's resources are insufficient to pay expenses. This money is to be repaid with interest.

Economic conditions in key industries—oil and agricultural products—contributed to the rapid expansion and subsequent record default payments in the program. The program's portfolio rose from less than $2 billion at the end of fiscal year 1973 to more than $8 billion by the end of fiscal year 1982. However, in the 1980s the price of oil declined sharply and agricultural exports decreased, leading to depressed operating conditions for certain vessels guaranteed under the program and to an upsurge in defaults starting in 1985. Marad expects depressed conditions in several maritime segments to continue throughout this decade.

Results in Brief

Of the fund's approximately $5 billion in outstanding loan guarantees as of September 30, 1986, about $1 billion, or 20 percent, was considered by Marad to be at risk of default.

By the end of fiscal year 1985, the fund was not self-supporting, and the condition worsened in fiscal year 1986 when default payments exceeded

$1.2 billion, the highest level in the program's 15 years. The fund was not self-supporting because it was unable to generate revenues sufficient to cover its expenses without the aid of Treasury borrowings. Marad is required to repay these borrowings but was able to do so only with a supplemental appropriation of nearly $1.4 billion. Treasury borrowings are covering the bulk of program expenses in fiscal year 1987.

GAO identified several problems relating to Marad's program, financial, and budget data, including reporting inconsistent data on the total value of outstanding loan guarantees and commitments for fiscal year 1985, not having a complete list of troubled companies, not establishing a required liability for future losses on loans, and significantly underestimating fiscal year 1986 default payments.

Department of Transportation and Marad officials have taken or plan to take corrective action in nearly all of the above areas. However, Marad needs to state clearly in its annual reports that the fund is not self-supporting when projected fund revenues are not sufficient to cover expenses and pay back Treasury borrowings without the aid of supplemental appropriations. This will permit the Congress to make more-informed decisions.

Principal Findings

Fund Is No Longer Self-Supporting

The fund had a deficit of $250 million for fiscal year 1985 and borrowed over $1.2 billion from the Treasury to cover expenses for fiscal year 1986. The Secretary of Transportation received a supplemental appropriation to repay the debt and interest incurred through fiscal year 1986. Furthermore, Marad projects a deficit of more than $500 million for fiscal year 1987.

Neither Marad's 1985 nor 1986 annual reports stated that the fund is no longer self-supporting. Such a statement is important because (1) Marad is no longer able to repay its expenses, including Treasury borrowings, without a supplemental appropriation and (2) it would make more useful and complete information available to support the Congress's policy-making and oversight responsibilities especially with respect to approving supplemental appropriation requests.

Program Data Have Been Improved

In several documents as of September 1985, Marad reported inconsistent data on the total value of its portfolio that differed by up to $400 million. In addition, Marad does not have a complete list of companies at risk of default and their loan balances. In one document Marad omitted over $700 million in troubled loans. However, Marad has provided consistent data in internal and external reports of its total portfolio as of September 30, 1986. In addition, Marad officials are preparing a complete list of companies at risk of default. (See ch. 3.)

Financial Statements Are More Complete

GAO pointed out in June 1985 and December 1986 that Marad's fiscal year 1985 annual report did not include a liability for expected yearly losses on its outstanding loan guarantees as required by Comptroller General criteria. Marad established such a liability in its fiscal year 1986 annual report. (See ch. 4.)

Default Estimates Are Being Prepared

Marad originally stated that it was not possible to prepare a realistic estimate of loans in its portfolio at risk of default. GAO disagreed and, for illustrative purposes, used the fund's recent experience to prepare an estimate—$524 million for fiscal year 1987. Marad officials later agreed that they could prepare yearly default estimates and have estimated defaults at $600 million for fiscal year 1987. Marad officials said the estimate is based on an analysis of company and market conditions and trends. (See ch. 4.)

Documentation of Processes Is Needed

Marad officials stated and GAO agreed that they had made the improvements in program, financial, and budget data that were discussed earlier in this summary, including developing a list of companies at risk of default and estimating future default payments. However, GAO was unable to review Marad's process for developing these data because Marad did not document the process. Such documentation is important to ensure that the data were properly compiled. Documentation will also enable Marad's processes to be independently reviewed. (See chs. 3 and 4.)

Recommendations

GAO recommends that the Secretary of Transportation require Marad's Administrator to (1) state in its annual report and elsewhere, as appropriate, that the fund is no longer self-supporting and (2) document the processes used to compile data on companies at risk of default and the estimates of default payments used in financial and budget documents. (See chs. 2, 3, and 4.)

GAO also recommends that Marad's Administrator report at the end of this calendar year to the Secretary of Transportation on those financial reporting areas identified in this report where corrective action has not been taken, including any areas of nonconformance in Marad's accounting system with the Comptroller General's principles, standards, and related requirements. (See ch. 4.)

Agency Comments

In commenting on a draft of this report, the Department of Transportation noted improvements in program, financial, and budget data to address the problems GAO identified. Although its comments do not address the need for documentation of the processes for compiling such data, the Deputy Associate Administrator for Maritime Aids generally agreed that documentation is important and plans to consider ways of preparing such documentation. These actions, if properly implemented, should resolve the problems.

However, the Department noted that its annual reports show that expenses exceed revenues and thereby disclose that the fund is not self-supporting. GAO agrees that one can determine from reading the reports that expenses exceeded revenues but believes the annual reports would be more useful and complete if they clearly stated that the fund is no longer self-supporting because the fund will not generate revenues to repay Treasury borrowings without the aid of supplemental appropriations. This would make clear that without the aid of appropriations, expenses will continue to exceed revenues.

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Abbreviations

DOT	Department of Transportation
GAO	General Accounting Office
Marad	Maritime Administration
RCED	Resources, Community, and Economic Development Division

Chapter 1

Introduction

The Federal Ship Financing Program (commonly called title XI) was established by title XI of the Merchant Marine Act of 1936 primarily to encourage the construction of vessels in the United States. The act was amended in 1972 to, among other things, attract more private capital for vessel construction. Under the 1972 amendments, guarantees backed by the full faith and credit of the United States are issued to U.S. citizen shipowners. Prompt payment in full of the interest and the unpaid principal of any loan guarantee is provided for under this program by the U.S. government in the event a shipowner defaults in the payment of any principal and interest on the loan guarantee when due. The vessels usually form the security for the government's guarantee of the loans.

Funds for vessel construction are obtained by the shipowner's issuance of corporate bonds to private sector investors, such as banks, pension trusts, life insurance companies, and the general public. The bonds have a maximum maturity of 25 years. The program is administered by the Department of Transportation's (DOT) Maritime Administration (Marad).

By law, the total outstanding amount in loan guarantees for vessels cannot exceed $9.5 billion at any given time. According to Marad's records, its portfolio (outstanding loan guarantees and commitments) amounted to about $5 billion in September 1986. Thus, Marad could have guaranteed an additional $4.5 billion. However, in fiscal years 1980 through 1986, the Congress specified a limit on the value of new commitments in each year's appropriation. For example, Marad was limited to $67 million in fiscal year 1986. No limit for fiscal year 1987 has been enacted.

Marad's fiscal year 1988 budget request has proposed that new loan guarantee commitments and the authority to issue loan guarantee commitments be terminated. However, even if Marad does not guarantee any new loans or loses its authority to issue new commitments, it will still be custodian over the existing portfolio.

The Federal Ship Financing Fund underwrites the program. The fund receives income from (1) fees (determined by Marad in accordance with statutory limits) paid by shipowners whose loans are guaranteed, (2) interest on investments in Treasury securities, (3) proceeds from the repayment of loans or the sale of vessels acquired by Marad after it makes default payments, and (4) repayment of federal loans. Expenses, including those to pay loan defaults and maintain vessels acquired through default, are paid from the fund.

When a vessel owner does not make loan repayments, investors or their agents may call the loan into default, thus requiring Marad to pay from the fund the outstanding principal plus accrued interest. If the fund's resources are not sufficient to cover these costs, Marad is authorized to borrow the money from the Treasury. The fund is required to repay this money, with interest. To help recoup the costs of a default, Marad will foreclose on and attempt to obtain title and sell the vessel that is security for the loan guarantee. Proceeds from the sale are credited to the fund.

Objectives, Scope, and Methodology

In a letter dated December 20, 1985, the former Chairman, Subcommittee on Merchant Marine, House Committee on Merchant Marine and Fisheries, asked us to provide information on certain aspects of Marad's Federal Ship Financing Program and Fund. As agreed with his office, we compiled and analyzed information to answer the following questions:

- What portion of companies with loan guarantees is considered to be at risk of default?
- What is the financial condition of the fund that finances the program?
- Does Marad maintain reliable data on the program's loan guarantees and companies at risk of default?
- Do the fund's financial statements properly recognize potential defaults on outstanding loan guarantees?
- How accurate are Marad's estimates of expected defaults?

We performed our review at Marad headquarters in Washington, D.C. We interviewed Marad officials to obtain information on the companies that Marad considered to be at risk of default ("troubled"). We also obtained and analyzed reports and other documents that contained data on troubled companies to determine what portion of Marad's loan guarantee portfolio was troubled. In addition, we tracked the progress of selected troubled companies to determine whether these companies ultimately repaid their loans or defaulted on them.

To determine the financial condition of the fund, we reviewed financial statements and other budget documents. We interviewed Marad officials to determine the reasons for the fund's financial condition and to find out what information is available on the portfolio.

To determine the reliability of the data on the portfolio, we reviewed reports and other documents, including files on companies with loan guarantees. We did not attempt to assess the adequacy of Marad's management information system for the program. We focused instead on two basic measures on which we had been asked to compile data: (1) loan guarantees and commitments and (2) the number of troubled companies.

We did not review Marad's entire accounting system to determine whether it conformed to the Comptroller General's principles, standards, and related requirements. Instead, to answer the Chairman's questions on how default payments and future default estimates were shown, we concentrated on the portion of the system dealing with the financial statements that Marad had prepared. We reviewed the financial statements and other budget documents to determine whether the financial condition of the fund had been properly disclosed. In addition, we assessed whether Marad's estimates of expected defaults were reasonable.

Our review was conducted in accordance with generally accepted government auditing standards except that we did not independently verify all of the data Marad provided. We performed our review primarily between December 1985 and July 1986, but in certain instances, we performed additional audit work beyond July 1986 in order to update data that Marad had provided. This additional work was completed in July 1987.

In order to simplify our discussion of Marad's loan guarantee portfolio, we use the term "loan guarantee amounts" to refer to that portion of Marad's portfolio represented by companies that have loan guarantees with outstanding principal balances. Unless specifically stated, interest Marad paid for defaulted loan guarantee amounts has not been added.

DOT's Office of the Inspector General also evaluated the effectiveness of Marad's policies and practices in managing selected areas of the title XI program.[1] The objectives of the audit were to evaluate (1) the fund's financial management practices, (2) the adequacy of decisions to provide assistance to troubled companies, and (3) actions to maintain and dispose of vessels obtained through defaults.

Our report and the Inspector General's report generally cover different aspects of the title XI program and fund. For example, we concentrated our efforts on information developed and disseminated by Marad to answer questions on the program's and fund's status with respect to troubled companies and loan guarantees and increasing default payments. The Inspector General report also addressed the fund's financial situation but evaluated Marad's financial decisions to approve financial aid for several troubled companies and Marad's vessel disposal practices after default payments had been made. In addition, the Inspector General Office's audit work was performed, in some cases, at various locations outside Washington, D.C. The report identified weaknesses in these areas and recommended corrective actions. Its findings are summarized and discussed in our report where appropriate.

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[1] Report on Audit of the Management of the Federal Ship Financing Guarantee Program, AV-MA-6-040 (Sept. 4, 1986).

Agency Comments

On December 24, 1986, we provided DOT with copies of our proposed report for its official review and comment. DOT provided comments on April 7, 1987. Its comments, along with our evaluation of them, are summarized in the remaining chapters of this report. The text of DOT's comments with our supplemental views is included as appendix I.

Chapter 2

Marad Should Report That the Fund Is No Longer Self-Supporting

The fund's expenses have exceeded its revenues, and expenses are now covered primarily by borrowing funds from the Treasury. The fund was not self-supporting in 1985, and this condition worsened in 1986 because of an unprecedented number of defaults, which were largely due to economic conditions.[1] However, Marad did not state that the fund is no longer self-supporting in its 1985 and 1986 annual reports. On the basis of Marad's own projections, the fund will not be self-supporting through fiscal year 1987. The Congress would have more useful and complete information on which to base policy decisions if the fund's complete financial condition were clearly presented. In addition, a portion of the portfolio is still at risk of default.

In its comments, DOT said that the fund's financial statements and other documents disclosed that expenses exceeded revenues. However, we believe that the statements would be more useful, clear, and complete if they also state that the fund is no longer self-supporting—a condition the fund had not experienced in prior years. This statement should be included because Marad is not in a position to repay Treasury borrowings, thus necessitating requests for future congressional appropriations to pay its expenses.

Fund Expenses Exceed Its Revenues

Fiscal year 1984 was the last year the fund's revenues exceeded its expenses—by about $27 million. The fund's expenses surpassed its revenues in fiscal years 1985 and 1986; to cover default payments, it borrowed from the Treasury about $130 million for fiscal year 1985 and over $1.2 billion for fiscal year 1986.

Between 1972, when the program started to guarantee loans, and 1986, about $1.9 billion in default payments were made, with 82 percent of the total being paid in fiscal years 1985 and 1986. Cumulative payments of about $5 million were made before fiscal year 1977; over $336 million was paid between fiscal years 1978 and 1984. However, such payments increased to about $321 million in fiscal year 1985 alone and to over $1.2 billion in fiscal year 1986. (See fig. 2.1.)

When the fund's revenues and surplus are not sufficient to meet expenses, Marad borrows from its unlimited line of credit with the Treasury to cover expenses, including defaults. Prior to fiscal year 1985,

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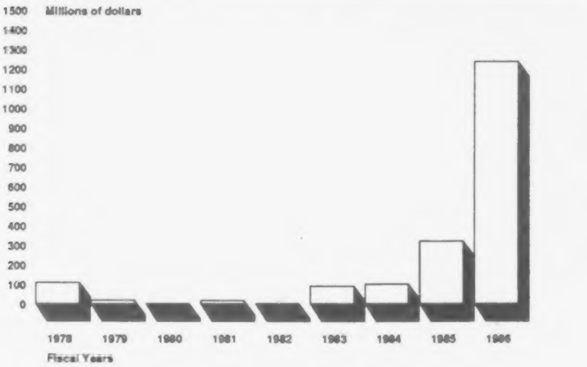
[1] As used in this report, self-supporting means the ability of the Federal Ship Financing Fund during the fiscal year to draw upon the fund's balance and/or to generate revenues in amounts sufficient to pay all expenses, including default payments and Treasury borrowings, without congressional appropriations.

Marad borrowed four times from the Treasury to cover default payments and in each case repaid the borrowings without seeking an appropriation. However, Marad has not received sufficient revenues to repay the borrowings that started in fiscal year 1985. Marad had borrowed almost $1.4 billion by the end of fiscal year 1986 and reported paying about $74 million in fiscal year 1986 to cover interest on its debt to the Treasury. In fiscal year 1987 (July 11, 1987), DOT received a supplemental appropriation for $1.375 billion to cover Marad's expenses from fiscal years 1985 and 1986.

Marad projects that borrowings will continue through fiscal year 1987. Through June 22, 1987, Marad made payments of over $312 million to cover defaults—more than the $94 million of revenue it projects for the entire year. Marad projects that for fiscal year 1987 it will make default payments of $600 million and borrow over $547 million to cover these payments. We believe DOT will request another supplemental appropriation in fiscal year 1988 to repay the Treasury debt incurred in fiscal year 1987.

Figure 2.1: Default Payments From the Federal Ship Financing Fund, Fiscal Years 1978-86



The Fund's Statement of Operations Did Not State That It Was Not Self-Supporting

Although the fund was established with the intention of being maintained from revenues generated primarily from companies seeking guaranteed loans, by the end of fiscal year 1985, the fund was not self-supporting. Marad's fiscal year 1985 annual report's statement of operations (dated July 1986) showed that expenses were greater than revenues, and the statement of financial condition indicated borrowings from the Treasury.[2] We believe that the statement of operations in the 1985 annual report would have been more useful and complete if it had clearly stated that the fund is no longer self-supporting. That is, we believe Marad will request another supplemental appropriation to repay Treasury borrowings that will occur in fiscal year 1987.

The Accounting and Auditing Act of 1950 vests in federal agency heads the primary responsibility for establishing and maintaining adequate systems of accounting and internal control. These systems must conform to the Comptroller General's principles, standards, and related requirements. One of the Comptroller General's accounting standards prescribes the financial reporting that agencies follow in preparing and issuing financial statements. This standard, in part, requires financial statements to contain useful and complete data.

The Merchant Marine Act of 1936 (section 208), as amended, requires Marad to prepare an annual report covering, in part, its activities in administering federal maritime programs, including the title XI program. The report also contains financial statements and is sent to the President and the Congress and is available to the public.

Marad's 1985 statement of operations did not—in a footnote or otherwise—state that the fund was no longer self-supporting. Such a recognition is important because, for the first time, Marad received a supplemental appropriation for nearly $1.4 billion in fiscal year 1987 to cover expenses in fiscal years 1985 and 1986.

Further, Marad's 1986 annual report also does not state that the fund is not self-supporting.[3] It does indicate that expenses exceeded revenues by about $755 million and that Marad continued to borrow from the Treasury to cover default payments totaling over $1.2 billion. Marad's

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[2] MARAD '85: The Annual Report of the Maritime Administration for Fiscal Year 1985, U.S. Department of Transportation, Maritime Administration (July 1986).

[3] MARAD '86: The Annual Report of the Maritime Administration for Fiscal Year 1986, U.S. Department of Transportation, Maritime Administration (June 1987).

1986 year-end financial statements to the Treasury Department showed similar amounts.

Moreover, Marad's budget documents for fiscal year 1987 and 1988 did not state that the fund is no longer self-supporting. (Budget documents are used to justify an agency's request for appropriations to perform its activities and operations.) Since the fund's expenses for fiscal year 1987 have already exceeded its projected revenues, Marad has continued its Treasury borrowings to pay off defaults. Marad estimates that it will borrow over $547 million in fiscal year 1987. We believe Marad will seek another supplemental appropriation to repay these borrowings.

The 1986 annual report and other documents should have stated that the fund is no longer self-supporting at least through fiscal year 1987. If this had been done, the Congress and other decisionmakers would have more useful and complete information on which to base policy decisions.

Economic Changes Affected Title XI Default Payments

The program's rapid expansion in the 1970s and its troubles in the 1980s were due largely to the shifting fortunes of two key industries—energy and agriculture.[4] The program's portfolio was less than $2 billion at the end of fiscal year 1973. It rose to a peak of more than $8 billion by the end of fiscal year 1982 and declined to about $5 billion by the end of fiscal year 1986.

Dramatic increases in oil prices in 1973-74 and 1978-79 led to a national effort to decrease U.S. dependence on imported energy sources. Part of this effort was program assistance for energy-related vessels, including domestic tankers and drill rigs. During the same period, a significant increase in agricultural product exports occurred that led to more requests for assistance to construct inland tugs and barges.

However, a sharp decline in oil prices in the 1980s has reduced the demand for drill rigs and other energy-related vessels. Similarly, agricultural exports have not been sustained at expected levels. Lower demand for vessels in both markets resulted in lower freight prices, reduced economic viability, and increased defaults. Marad reports project that several maritime segments will probably continue to experience depressed economic conditions through the remainder of this decade.

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[4] This section is based primarily on the remarks of Garrett E. Brown, Jr., Acting Deputy Maritime Administrator, before the Subcommittee on Merchant Marine, House Committee on Merchant Marine and Fisheries, on June 25, 1986.

Most Companies Judged at Risk Defaulted

We tracked the progress of 58 companies that Marad categorized as troubled as of November 1985.[5] These companies had a combined loan guarantee amount of over $1.6 billion. By January 1987, 39 of them (about 67 percent) had defaulted; their loan guarantee amounts were about $927 million. Marad paid these 39 companies' creditors an additional $61 million to cover interest, bringing the total payments to over $988 million.

A Portion of the Program's Portfolio Is Still Troubled

The increase in defaults in the last 2 fiscal years did not cleanse the program's portfolio of all troubled loans. Instead, 20 percent of the total loan guarantee amount of about $5 billion as of September 1986 (the end of fiscal year 1986) was still in danger of default, according to our analysis of Marad data. Our analysis also showed that the troubled portion included 30 percent of the loan guarantees, 15 percent of the vessels, and 23 percent of the companies. (See fig. 2.2.)

Despite the defaults in the 12 months after November 1985, the number of troubled companies as of December 1986 remained stable while the value of troubled loans declined. Of the 58 troubled companies as of November 1985, 39 defaulted and were removed from the list. However, 36 new companies were added during that period, yielding a list of 55 companies as of December 1986. The November 1985 list included 58 companies, with loan guarantee amounts totaling $1.6 billion; the December 1986 list included 55 companies, with loan guarantee amounts totaling over $954 million.

Marad officials said they had reviewed the entire portfolio to identify the complete troubled portion for November 1985 and December 1986. We did not verify the completeness of these lists because Marad officials said they had not documented the process they used that would allow us to independently verify the thoroughness of Marad's process and the reliability of its results. (Ch. 3 provides a more complete discussion of Marad's process for identifying and listing troubled companies.)

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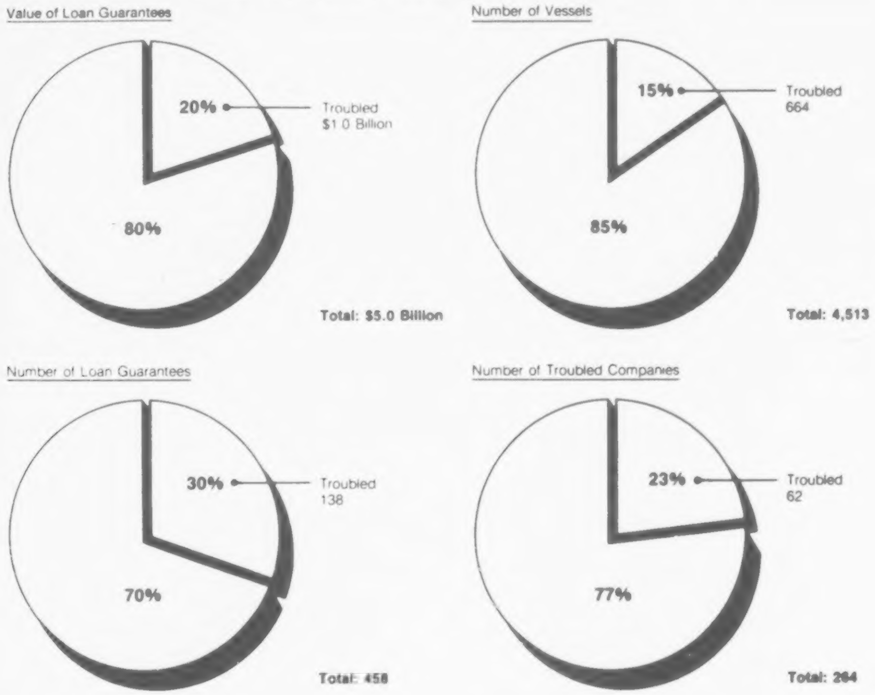
[5] When we began our review in December 1985, Marad provided an initial list of 44 companies troubled as of November 1985. The list was the latest available information on troubled companies, at the time we began our audit work, that was comparable to information on the total loan guarantee portfolio. This list was later expanded to 58 companies by adding 14 companies that should have been included on the initial list.

Figure 2.2: Troubled Loan Guarantees as a Portion of the Total, as of September 30, 1986



Conclusion

The Federal Ship Financing Fund is no longer self-supporting, a condition caused primarily by economic factors. Marad has not stated this in its annual reports' financial statements or other budget documents. Prior to fiscal year 1985, it paid expenses and repaid borrowed funds by generating its own revenues. The statement that the fund is no longer self-supporting is needed because in the past, Marad never repaid expenses of the fund with a congressional appropriation. Marad's financial documents will be more informative to the Congress and other decisionmakers when they are clearer and more complete.

Recommendation to the Secretary of Transportation

We recommend that the Secretary of Transportation direct Marad's Administrator to improve the financial information in Marad's annual report and budget documents by clearly stating that the fund is no longer self-supporting. This statement should continue to appear in future annual reports and budget documents until the fund's own revenues are sufficient to pay all expenses, including default payments, within the same fiscal year, and Treasury borrowings within the next fiscal year, without the aid of supplemental appropriations.

Agency Comments

In a draft of this report, we proposed that the condition of the fund be clearly and prominently displayed to decisionmakers. DOT responded that Marad's financial statements did disclose that the fund's fiscal year 1985 expenses exceeded revenues by over $250 million. Although we do not dispute this, we believe that Marad should state explicitly that the fund is no longer self-supporting in its annual report's financial statements and budget documents for two reasons. First, in previous years, Marad had borrowed from the Treasury to cover shortfalls in the fund when expenses exceeded revenues and had repaid these borrowings as required. However, unlike the previous borrowings, Marad was able to repay fiscal years 1985 and 1986 borrowings only with a supplemental appropriation because the fund did not generate income sufficient to pay expenses.

Second, we believe that Marad's statements and documents will be more informative if they state—in a footnote or otherwise—that the fund is no longer self-supporting. Simply disclosing that expenses have exceeded revenues and that Treasury borrowings have occurred does not inform the Congress and other users of Marad's financial statements that the fund is no longer a revolving fund (self-supporting) and will not be able to pay its expenses, including default payments, without borrowing from the Treasury. This condition was not stated in the fiscal year 1985 and 1986 annual reports, or in Marad's fiscal year 1987 or 1988 budget submissions.

As stated earlier in this chapter, Marad's own projections indicate that Treasury borrowings will continue through fiscal year 1987. The fund has unlimited borrowing authority with the Treasury; however, we believe revolving funds are intended to be generally self-supporting and should not be maintained with Treasury borrowings. Therefore, we have not withdrawn our recommendation.

Chapter 3

Management Data Have Been Improved

The Federal Managers' Financial Integrity Act of 1982 requires federal agency managers to establish adequate internal control systems. These systems must conform to the Comptroller General's criteria. One criterion states that an agency must document its significant activities.

We found that Marad reported inconsistent data on the total value of outstanding loan guarantees and commitments[1] for fiscal year 1985. We also found that Marad has no complete list of companies at risk of default that includes statistical and profile data on each company. However, Marad has made improvements in these areas, and when it documents the process for deciding which companies are at risk of default and which loan guarantees it is likely to pay, we believe that the data will be more useful and complete.

Why Management Controls Are Needed

In 1983 the Comptroller General issued Standards for Internal Controls in the Federal Government to implement the Federal Managers' Financial Integrity Act. That issuance contains internal control standards to be followed by executive agency managers in establishing and maintaining systems of internal control. Internal controls are the plan of organization and methods and procedures adopted by managers of executive agencies to ensure that resource use is consistent with laws, regulations, and policies. Managers must also ensure that resources are safeguarded against waste, loss, and misuse and that useful and complete data are obtained, maintained, and fairly disclosed in reports.

One of the internal control standards is documentation, which requires, among other things, written evidence of all pertinent aspects of agency transactions and other significant activities. Federal agency managers must document transactions and other significant activities completely and accurately in order to facilitate tracing the transaction or event and related information from before it occurs until after it is completed.

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[1] After initially approving an application for a loan guarantee, Marad issues a "commitment" to the applicant, which guarantees the obligation and states the requirements necessary for final approval. Marad's commitment is generally based on the estimated cost of the vessel, while a loan guarantee is generally based on the actual cost of the vessel after final approval. A single commitment or guarantee can cover more than one vessel.

Data on the Total Value of Loan Guarantees and Commitments Have Improved

In fiscal year 1985 Marad reported inconsistent data—sometimes containing significant disparities—in several documents on the number and value of outstanding loan guarantees and commitments and on other basic program data. These data are basic to program management and oversight.

The loan guarantee principal balances for the companies in Marad's portfolio are updated on the basis of information obtained from the companies and their investors. Commitments are then added to arrive at the total value of outstanding loan guarantees and commitments. The Office of Ship Financing publishes the updated information semiannually, at the end of March and September.

Useful and complete data on the portfolio are needed to provide managers with a basic framework for making decisions about program management and to provide assurances to the Congress and the public that managers know the magnitude of the program resources for which they are responsible and to help ensure that the agency's data are credible. Lack of consistency in program totals raises questions—first, about the accuracy of the company-specific figures that are summed up to yield totals and second, about the general credibility of the program's management and data.

We also identified other disparities in Marad's data on individual companies' outstanding loan guarantee amounts and in the number of vessels for which a guarantee had been made. However, the examples below relate only to disparities in the figures represented as the program's total outstanding loan guarantee and commitment amounts in September 1985.

A financial statement, as of September 30, 1985, was prepared by Marad's accounting office and sent to the Treasury Department. This statement contained a schedule that represented the program's total outstanding loan guarantee and commitment amounts as $6.7 billion; a report for the same date prepared by Marad program officials for internal use represented these amounts as $6.5 billion. Another report, prepared by Marad program officials for the Marad Administrator in September 1985, reflected a balance of $6.9 billion for the program's total outstanding loan guarantees and commitments. This figure was identical to one that was represented as current in June 1985 and appeared in Marad's testimony before the House Subcommittee on Merchant Marine. Marad officials told us in June 1986 that the $6.9-billion balance was actually current as of the end of March 1985.

We asked Marad officials in June 1986 to account for these differences. They attributed them to such factors as omitting qualifying explanations or footnotes from financial statements and incorrectly reporting how current the information was. In April 1987 Marad officials said that all future reports and presentations will include qualifying explanations and footnotes as appropriate. We reviewed Marad's fiscal year 1986 documents and testimonies and noted that the total value of outstanding loan guarantees and commitments is consistent throughout.

Marad Is Developing a Complete List of Troubled Companies

Marad now is compiling a current, complete list of troubled companies. Such data are basic to program management and oversight. However, in order to ensure that the list is credible and complete, Marad needs to document the process used to decide which companies are troubled.

According to Marad officials, they periodically review the financial situation of every company with a loan guarantee to determine whether the company is likely to have difficulty making its loan repayments. Loan examiners have been told to consider such factors as whether a company's financial statements reflect a negative cash flow, whether a downturn has occurred in the market in which the company's vessel operates, and whether the company has had problems in the past making loan repayments.

When the loan examiners determine that a company is likely to have difficulty making its payments because of these factors, Marad classifies the company as troubled and places it on a "credit watch" report.[2] Marad established this report in 1983 because of an increase in defaults; and according to officials, it is usually prepared monthly as a management information and tracking tool to monitor the troubled companies and their progress in overcoming their financial difficulties.

When we began our work, we obtained from Marad the November 1985 credit watch report, which listed 44 companies with aggregate loan guarantee principal balances of over $939 million for 756 vessels. We were told initially that this was a complete listing of troubled companies. However, we later learned that the report omitted certain companies.

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[2] We did not review the adequacy of Marad's criteria for identifying a troubled company or the procedures by which the list of troubled companies was compiled.

At our request, the Marad program office identified another 14 companies that met Marad's criteria as being troubled. Through a review of other Marad documents, we found that these additional companies had loan guarantee principal balances totaling about $700 million for 1,631 vessels. The 14 companies, according to Marad officials, had not been included in the report because their identity and financial distress were assumed to be "common knowledge" within Marad.

Thus, the initial November 1985 list was not complete as of that date and the omissions were significant. Relative to the updated list that was prepared at our request, the companies that were not initially listed represented

- 24 percent (14) of the 58 companies identified as troubled,
- 68 percent (1,631) of the 2,387 vessels associated with troubled companies, and
- 43 percent ($700 million) of $1.6 billion in loan guarantee principal balances considered troubled.

When we asked Marad officials why they did not routinely compile complete data on troubled companies, they told us they were satisfied to rely on their staff to provide data as needed. They also said that program managers were aware that no complete list of troubled companies existed, and therefore this would not hinder Marad in managing the program.

The Deputy Associate Administrator for Maritime Aids, in January 1987, agreed that a complete listing of troubled companies had not been prepared but said that Marad would prepare the list. We asked him to prepare a listing of troubled companies as of September 30, 1986, for us to compare the troubled portion to the total value of Marad's loan guarantee portfolio for the same date. We also asked for the troubled portion as of December 31, 1986, which was the date of the latest credit watch report.

He provided these lists and stated that in preparing them, Marad officials had reviewed the status of every company and its loan guarantees to assess whether they could potentially become troubled. In addition, he said the officials discussed the current status of each company with loan examiners and other Marad officials. However, he told us that Marad had not documented how the lists had been prepared. Consequently, we were unable to verify whether and how the entire portfolio had been reviewed.

In our opinion, Marad will have better assurance that the list is credible and complete once loan examiners document the process for deciding which companies are troubled. Documentation is important for several reasons. It helps managers control their operations by providing assurance that processes were properly followed and that the processes and their results are recorded. Documentation also helps assure interested parties outside the organization that agency decisions were soundly based and agency data are useful and complete. In addition, documentation provides internal and external auditors with a basis for independent verification of the agency's processes and results. (We also used this criteria in ch. 4 when we discuss the need for Marad to document its process for estimating potential default payments.)

The list of troubled companies should include not only the names of the troubled companies but also the principal balances, loan guarantees that are in danger of default, number of vessels, and other pertinent data needed to present a clear picture of the companies' circumstances.

Conclusion

Federal managers must ensure that useful and complete data are obtained, maintained, and fairly disclosed in reports in accordance with the Comptroller General's criteria for internal controls. Marad now has prepared and disseminated consistent figures on the total value of loan guarantees and commitments for fiscal year 1986. In addition, Marad is preparing a complete list of companies at risk of default. However, Marad has not documented the process it used to prepare the list. Without this documentation, Marad has no assurance that the list is credible and complete. The documentation should include the names of each troubled company, its circumstances, and other pertinent information.

Recommendation to the Secretary of Transportation

We recommend that the Secretary of Transportation direct Marad's Administrator to document Marad's process for compiling a list of companies that are considered to be at risk of default to ensure that each company's circumstances are reviewed thoroughly and consistently.

Agency Comments

In a draft of this report, we proposed that the Secretary of Transportation direct Marad's Administrator to compile useful and complete data on the total value of outstanding loan guarantees and commitments. We also proposed that the Administrator compile useful and complete data on the portion of the loan guarantee portfolio that is considered to be at risk of default.

In its comments, DOT said that Marad does have accurate information on its loan portfolio. DOT also said that the two documents we discussed, covering the total value of outstanding loan guarantees and commitments for the same period, had been prepared for different purposes and therefore did not display the same information. We disagree that this explains the difference in data. The 1985 financial statement we obtained from Marad's accounting office contained a schedule that had a total figure for outstanding loan guarantees and commitments without an explanation or footnote on the schedule as to what composed the total. This figure differed by $200 million from a report showing the total value of outstanding loan guarantees and commitments for the same date used by the program office handling title XI loan guarantees.

Further, the figures Marad prepared for these documents as well as others dated September 1985 for the total value of its loan portfolio differed by as much as $400 million. Regardless of the purpose of the reports or presentations, Marad officials should either report consistent data or properly characterize the data to avoid the confusion that may result if different figures are reported for the total amount of the portfolio. In its comments, DOT conceded that the presentations made for the Administrator and the congressional committee should have indicated the correct reporting period.

With regard to accuracy, 14 of the 44 companies whose loan guarantee principal balances, which are part of the total portfolio, varied in amounts ranging from $35,000 to over $6 million in the reviewed program reports for the September 1985 period. Variances also occurred in the number of vessels for several companies. We did not compare all of the over 300 companies' loan balances and the number of vessels that comprised the portfolio at that time, so we could not determine the amount of variance in the entire portfolio that may exist when different reports are used.

We believe that DOT and Marad have recognized the need for consistency because DOT also stated in its comments that although Marad presentations in general do contain adequate explanations, all future reports and presentations will include qualifying explanations and footnotes as appropriate. We reviewed Marad's fiscal year 1986 year-end documents and certain other related documents and noted that the total value of outstanding loan guarantees and commitments is consistent throughout.

(We did not review the loan balances and number of vessels for individual companies.)

DOT also commented that although a single list of troubled companies does not exist, Marad program officials had updated information on all troubled companies. We believe that a single complete list of troubled companies, with pertinent statistical information on each company's circumstances as described earlier in this chapter, would be more useful to Marad and DOT managers than several reports and documents in presenting a complete picture of the number and value of such companies.

Again, DOT and Marad officials said they recognize this need. DOT stated that a single report specifically addressing all troubled companies may be a useful mechanism for consolidating information for management and that Marad is in the process of reestablishing procedures to produce a single complete list of troubled companies. We believe that when Marad has established this list with appropriate statistical information on each troubled company, our proposal will be properly implemented. Because of DOT's active commitment to improve this area, we are not making a recommendation at this time.

However, because Marad did not document its process for compiling the lists of troubled companies, we could not verify the process for compiling them. Therefore, we have included a recommendation to address this. We discussed this recommendation with the Deputy Associate Administrator for Maritime Aids, who generally agreed with it.

Chapter 4

Improvements in the Fund's Financial Reports

Good financial management is dependent on strong systems, including accounting systems that contain useful financial information. Financial information is useful when, among other things, it is timely, relevant, reliable, cost beneficial, comparable, and consistent. Heads of executive agencies are required by the Federal Managers' Financial Integrity Act of 1982 to maintain adequate systems of accounting and internal control suited to the needs of their agencies and conforming to principles, standards, and related requirements prescribed by the Comptroller General. They are also required to report annually to the President and the Congress on their accounting systems' conformance or nonconformance with the Comptroller General's criteria. The report should include areas of nonconformance and the agencies' plans to correct the nonconformance.

The Federal Ship Financing Fund's fiscal year 1985 statement of financial condition in Marad's 1985 annual report of operations did not recognize future potential losses on outstanding loan guarantees and therefore is not in compliance with a Comptroller General standard. Marad also substantially underestimated default payments for fiscal year 1986. In addition, the problems discussed in the previous chapters—such as Marad's financial statements' not stating that the fund is no longer self-supporting, reporting inconsistent totals for the value of the loan portfolio, and not having a complete list of troubled companies—resulted in Marad's financial reports being less useful and complete than they could have been.

Marad has taken or planned corrective action for nearly all of the problems we identified. Marad's Administrator should report to the Secretary of Transportation any areas uncorrected at the end of this calendar year together with planned corrective actions. In this way, the Secretary will be better able to determine whether the remaining problems stem from internal control or accounting system weaknesses and, as appropriate, report them to the President and the Congress as required by law and ensure that necessary corrective actions are taken.

Marad Has Taken Steps to Improve Its Financial and Budget Data

Marad compiles various financial and budgetary data on the title XI program and disseminates them in different formats to several organizations and the public. The data include some similar elements relating to the program's current and expected financial situation. Of particular interest to us were the data, in both financial statements and budget documents, on possible default payments.

Marad prepares two types of financial statements at the end of each fiscal year. One type is required by the Treasury Department and the other is for Marad's annual report on its operations. Although we reviewed both types of statements, we concentrated our efforts on the annual report statement because it has a wider distribution, including the President and the Congress. The statement of financial condition in Marad's 1985 annual report did not include a liability to pay off expected defaults on loan guarantees. If Marad had established such a liability, it would have been in a better position to prepare realistic budget estimates. A report by the Inspector General also identified a weakness in Marad's financial reports.

In addition, Marad substantially underestimated the outlays needed to pay off defaulted loan guarantees in fiscal year 1986. Because of these underestimates, congressional and administration decisionmakers were not provided with useful and complete budget data for fiscal year 1986. Marad has taken steps to resolve this problem in fiscal year 1987.

Marad Established a Liability for Potential Loan Losses in 1987

Prior to fiscal year 1987, Marad officials did not establish a liability for yearly losses similar to that of other private financial institutions and government activities, as discussed earlier in this chapter. Instead, they compiled a quarterly figure for the amount they expected to pay off in defaults for companies whose investors notified Marad that defaults had already occurred.

Marad published in the budgets of the U.S. government the following default payment estimates for fiscal year 1986:

- in February 1985 (fiscal year 1986 federal budget) the estimate was $92 million and
- in February 1986 (fiscal year 1987 federal budget) the revised estimate was $500 million.

Actual default payments for fiscal year 1986 were over $1.2 billion.

The Accounting and Auditing Act of 1950 states that agency accounting systems must conform to the principles, standards, and related requirements prescribed by the Comptroller General. These are specified in the General Accounting Office's Policy and Procedures Manual for Guidance of Federal Agencies. Two of the main objectives of accounting standards are to (1) provide useful information to decide among alternative uses of resources and (2) determine whether resource allocation decisions implemented by agency management are proper and congressional intent has been met.

Among the standards is the requirement that probable losses on guarantees, loans, and other assets be recognized in accounting statements if the amount can be reasonably estimated. This principle is well established for private financial institutions and applies equally to government activities such as the fund. We have noted the omission of a liability for future loan losses in connection with other organizations, including the Export-Import Bank and the Federal Savings and Loan Insurance Corporation.[1]

We testified in June 1985 that, in reviewing the fund's financial statements, a liability and related expense had not been recognized for estimable and probable losses on outstanding loan guarantees.[2] The liability was not included in Marad's 1985 annual report on its operations dated July 1986. We discussed this with officials in Marad's Office of Accounting in July 1986, who told us that Marad could not reasonably estimate a liability for potential future yearly losses on outstanding loan guarantees. Therefore, they said, in accordance with generally accepted accounting standards, the liability need not be included in the annual report's statement of financial condition.

We disagreed that such a liability could not be reasonably estimated and prepared an estimate for the fund, which was included in our September 1986 report on the fiscal year 1987 budget reductions.[3] We developed this estimate for illustrative purposes only, to demonstrate that an estimate could be reasonably determined. Our approach for making this estimate involved judgment, just as determining a liability for loan guarantees, a common practice of financial institutions, is rarely subject to precise measurement. Whenever practical, estimates of future defaults should consider the wide range of developments affecting both individual vessels and the markets in which they operate. A measure that compresses all these factors into one value is the default rate.

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[1] With respect to the Export-Import Bank, see The Export-Import Bank of the U.S.: Financial Condition and Budget Issues (GAO/T-AFMD-87-15, May 21, 1987) statement of Frederick D. Wolf, Director, Accounting and Financial Management Division, before the Subcommittee on International Finance, Trade and Monetary Policy, House Committee on Banking, Finance and Urban Affairs. With respect to the Federal Savings and Loan Insurance Corporation, see Financial Audit: Federal Savings and Loan Insurance Corporation's 1985 and 1984 Financial Statements (GAO/AFMD-86-65, July 2, 1986). In 1985, for the first time, the Corporation began estimating potential losses attributable to troubled savings and loan institutions.

[2] Financial Aspects of the Maritime Administration's Title XI Federal Ship Financing Fund, statement of Dennis J. Duquette, GAO, before the Subcommittee on Merchant Marine, House Committee on Merchant Marine and Fisheries, June 25, 1985. We performed a limited review of the fund's financial aspects in preparation for the hearing. We did not audit the fund's financial statements for either the testimony or this report.

[3] Budget Reductions for FY 87: Review of Initial OMB/CBO Report Under the Deficit Control Act (GAO/OCG-86-4, Sept. 4, 1986), p. 17. This report reviewed the estimates to reduce the federal deficit prepared by the Office of Management and Budget and the Congressional Budget Office to implement requirements of the Balanced Budget and Emergency Deficit Control Act of 1985.

Before preparing our illustrative estimate, we asked Marad officials if they expected the default rate to change in fiscal year 1987. They stated that they expected the default rate to be somewhat lower than it was in 1986, but not dramatically lower. However, they did not explain why the default rate would be lower except to state that the 1986 default payments had removed most of the weaker companies, such as those that had had to operate in depressed markets with newer, high-cost equipment.

Using Marad's overall expectations of what would occur in fiscal year 1987, we arrived at a default rate of nearly 67 percent. This was approximately the rate at which companies classified as troubled defaulted in 1986. This default rate was then applied to the number of companies classified as troubled at the beginning of fiscal year 1987. The value of outstanding loan guarantees held by all of these companies was approximately $777 million. We estimated that nearly $524 million of these loans would default by the end of fiscal year 1987.

Later, in January 1987, Marad officials said they agreed that an estimate could be prepared, and they developed a liability for potential default payments for fiscal year 1987—$600 million. This estimate appears in the fiscal year 1988 budget of the U.S. government. A liability for fiscal year 1987 also appears in a footnote to the statement of financial condition in Marad's 1986 annual report, which was issued in June 1987.

Marad officials said that to prepare their estimate, they analyzed different companies and segments of the maritime industry and considered a wide range of variables. We agree that this approach should yield a more realistic estimate of potential default payments than simply projecting 1 year's experience into the future. We believe Marad has taken positive steps to prepare more realistic estimates starting in fiscal year 1987. However, we did not evaluate its methodology because Marad officials said that the process for preparing the liability had not been documented.

As discussed in chapter 3, documentation is important for several reasons, including helping managers control their operations, assuring interested parties outside the organization that agency decisions were soundly based, and providing internal and external auditors with a basis for independent verification of the agency's processes and results.

An Inspector General Report Found a Weakness in Marad's Financial Reporting

In its September 1986 report, the Inspector General's office also identified a weakness in Marad's financial reporting. The report found that Marad carried all of its $106 million in loans (advances) to troubled companies as assets when only 50 percent of the advances were likely to be collected.[4] The report also stated that since the fund will probably never repay the Treasury, Marad should not continue to list all of the advances as collectible because such a decision could affect budgetary decisions.

The report recommended that Marad annually project fund revenues and expenses and request appropriations for any anticipated shortfalls. In commenting on the final report, Marad said it would work "with the appropriate budget officials in the Department of Transportation to resolve this situation in a manner that is in the best interest of the Department."

Conclusion

Marad has taken or is in the process of taking action to correct nearly all of the financial and accounting reporting problems identified in this report. For example, Marad has established an estimate of $600 million for a liability for potential future losses on outstanding loan guarantees. It also is planning to make more realistic forecasts of anticipated default activity. Marad still needs to document the process it uses for establishing the liability estimate as well as for estimating potential future default activity. As noted in chapter 2, Marad also should ensure that its financial reports disclose that the fund is no longer self-supporting.

The actions taken or planned by Marad should result in its financial reports being more useful and complete than they have been in recent years. To the extent problem areas identified in this report remain uncorrected at the end of this calendar year, Marad should report these areas to the Secretary of Transportation to help facilitate DOT's compliance with the Federal Managers' Financial Integrity Act of 1982.

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[4] Marad can help financially troubled companies by making loans for such things as debt service payments. Marad makes loans to shipowners in financial trouble to help overcome a temporary negative cash flow. These loans are usually scheduled to be repaid within 2 years.

Recommendation to the Secretary of Transportation

We recommend that the Secretary of Transportation direct Marad's Administrator to document the process used to estimate Marad's liability for potential future losses on outstanding loan guarantees. Documentation should include a description of how each company's circumstances and market segment were considered in preparing the estimate.

Recommendation to the Maritime Administrator

We recommend that the Maritime Administrator report at the end of this calendar year to the Secretary of Transportation on those financial reporting areas identified in this report where corrective action has not been taken, including any areas in Marad's accounting system that do not conform with the Comptroller General's principles, standards, and related requirements.

Agency Comments

In our draft, we proposed that the Secretary of Transportation direct Marad's Administrator to establish a liability for potential future losses on outstanding loan guarantees. We also proposed that the Secretary of Transportation direct Marad's Administrator to prepare yearly estimates of potential future default payments.

In its comments, DOT said that it had established a liability for fiscal year 1987 and footnoted the amount of the liability in Marad's fiscal year 1986 financial statements, as we had proposed. We believe that with this action, Marad has been responsive to our proposal. Marad officials told us they had prepared this estimate by reviewing the entire portfolio and discussing each company with loan examiners and other Marad officials, but they had not documented the process they used. Since the process was not documented, it was not feasible to evaluate the soundness of the estimate. In addition, Marad could not ensure that the process had been followed in all instances. We therefore recommend that Marad document the process used for making its estimates. Marad officials told us they will take steps to ensure that the process is adequately documented in the future.

Our draft report used Marad's recent default experience and overall expectations of whether the fiscal year 1986 default rate would carry over into fiscal year 1987 to illustrate one technique for forecasting potential defaults. DOT may have misunderstood our intentions for including this in our draft report. We did not intend to imply that this was the only technique for making such estimates or even that it was preferable to a range of other available approaches. Our points were that Marad could and should develop potential future default estimates and that techniques were available for doing so. In fact, it is a common practice in the commercial and private sector.

Although they initially contended that a reasonable estimate of future defaults could not be made, in January 1987 Marad officials agreed that a reasonable estimate could be prepared and said they had developed a methodology (described earlier in this chapter) for analyzing different companies and segments of the maritime industry. We believe DOT's description of how estimates are now being prepared is both reasonable and responsive to our recommendation. However, to ensure that Marad's methodology for making estimates of potential future defaults is adhered to and can be monitored by management, we recommend that the estimating process be documented.

Our draft report also contained a chapter discussing the Federal Managers' Financial Integrity Act of 1982 and how it appeared to relate to the various financial reporting and accounting information problems identified in the report. The chapter proposed that the problems be classified as material weaknesses and reported in the Secretary's annual statement on internal controls to the President and the Congress. After considering DOT's comments and its response to our report, we determined that the chapter and proposal are unnecessary and have deleted them for the following reasons.

First, after reviewing our draft report, Marad has initiated or completed the following actions:

- Marad officials plan to include qualifying explanations and footnotes as appropriate when depicting the total value of outstanding loan guarantees and commitments in all future reports and presentations.
- In its comments, DOT stated that a single report specifically addressing all companies at risk of default may be a useful mechanism for consolidating information for management and that Marad is in the process of establishing procedures to produce a single complete list of companies at risk of default.
- Marad has established a liability for potential future losses on outstanding loan guarantees.

- Marad officials described a methodology they developed that considers factors necessary to prepare estimates of potential future default payments.

As our conclusions in this chapter indicate, Marad still needs to document its estimating process and include a statement in its financial reports clearly noting that the fund is no longer self-supporting. These actions, together with those already taken or planned, will result in Marad's financial and related reports being more useful and complete than they have been in recent years.

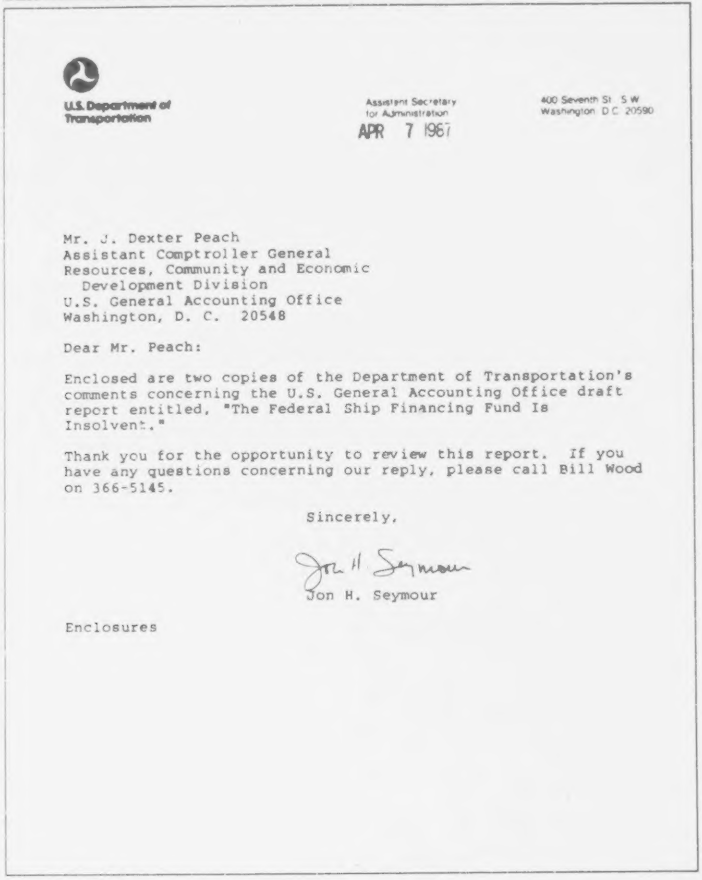
Second, several of the problems we identified, such as Marad's not establishing a liability for potential future defaults, relate to the conformance or nonconformance of Marad's accounting system with the Comptroller General's criteria for such systems. Problems of this type should be reported as part of the Secretary's annual report on DOT's accounting systems, regardless of whether the problems can also be considered internal control weaknesses. To the extent the areas of nonconformance are corrected—as is the case with the liability for potential future defaults—they need not be reported.

And, finally, DOT correctly pointed out that most of the problems identified by our review involve financial or accounting reporting problems and that these problems did not cause the financial difficulties currently facing the fund or the adverse publicity the fund has experienced. Nevertheless, we consider the reporting problems significant in that they have a direct bearing on the financial information available to provide necessary oversight and management of the fund. The reporting problems also may themselves be manifestations of systemic internal control or accounting system weaknesses. Although it was not within the scope of our review to examine the overall adequacy of Marad's process for annually identifying internal control and accounting system weaknesses and strengths, Marad's annual evaluations' inability to identify these financial information and reporting problems is cause for concern.

In view of the significant progress Marad has made in taking corrective action, Marad's most constructive approach would be to report to the Secretary, at the end of this calendar year, the remaining uncorrected areas with a plan for correcting each area. In this way, the Secretary will be in a position to determine whether the remaining problems stem from internal control or accounting systems weaknesses and, as appropriate, report them to the President and the Congress as required by law. In addition, Marad may find it beneficial to examine the adequacy of the processes it has in place for identifying problems with its internal control, accounting, and related systems.

Comments From the Department of Transportation

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



U.S. Department of Transportation

Assistant Secretary
for Administration

400 Seventh St. S.W.
Washington, D.C. 20590

APR 7 1987

Mr. J. Dexter Peach
Assistant Comptroller General
Resources, Community and Economic
Development Division
U.S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Peach:

Enclosed are two copies of the Department of Transportation's comments concerning the U.S. General Accounting Office draft report entitled, "The Federal Ship Financing Fund Is Insolvent."

Thank you for the opportunity to review this report. If you have any questions concerning our reply, please call Bill Wood on 366-5145.

Sincerely,

Jon H. Seymour

Jon H. Seymour

Enclosures

Enclosure

DEPARTMENT OF TRANSPORTATION REPLY

TO

GAO DRAFT REPORT

I. TITLE: Maritime Administration: The Federal Ship Financing Fund is Insolvent. Report No. GAO/RCED-87-58.

II. SUMMARY OF GAO FINDINGS AND RECOMMENDATIONS:

A. Loan Portfolio and Status of Federal Ship Financing Fund

See comment 1

GAO found that about one-quarter of the value of the loan portfolio as of March 1986 was troubled, 28 percent of loan guarantees were troubled, 37 percent of the vessels covered were troubled, and 22 percent of the companies with a loan guarantee were troubled.

See comment 2

GAO also found that the Fund's expenses exceeded its revenues. The Fund had a surplus of about $63 million in FY 1982, but had a deficit of $250 million by the end of FY 1985. In FY 1986, default payments reached $1.2 billion by July 1986.

B. Program Data

GAO concluded that MARAD could not readily provide accurate data on the total value of outstanding loan guarantees and commitments, and that MARAD did not have a complete list of troubled companies. GAO found that the data provided to them by MARAD on outstanding loan guarantees and commitments were inconsistent. Also, GAO initially reviewed data provided by MARAD on 44 troubled companies as of November 1985, but subsequently found that 14 additional companies were also troubled at that time and should have been on the original list.

GAO recommended that the Secretary of Transportation direct the Maritime Administrator to compile reliable data on the total value of outstanding loan guarantees and commitments and the portion of the loan guarantee portfolio that is considered to be troubled.

C. Accounting Documents/Financial Statements and Default Estimates

See comment 3

GAO found that MARAD's financial statements and other documents did not disclose that for FY 1985 the Fund's expenses exceeded revenues and, therefore, that the Fund was not self-sufficient. GAO also concluded that MARAD violated a Comptroller General accounting standard to establish a liability for expected payments for defaults on its outstanding loan guarantees.

See comment 4

GAO considered that MARAD's estimates of FY 1986 defaults, as shown in the proposed federal budgets for FY 1986 and FY 1987, were significantly underestimated. MARAD estimated in February 1985 that FY 1986 defaults would be $92 million; in February 1986, MARAD estimated that FY 1986 defaults would be $500 million. However, FY 1986 default payoffs were about $1.2 billion through July 1986, with MARAD estimating another $200 million during the balance of the fiscal year.

See comment 5

GAO believes that MARAD's original estimate of $100 million in default payoffs for FY 1987 is significantly low. GAO concluded that a more realistic estimate, based upon the Fund's recent experience, would have predicted defaults in FY 1987 more than five times MARAD's estimate.

See comment 6

GAO recommended that the Secretary of Transportation direct the Maritime Administrator to improve MARAD's financial and budget data by (1) clearly and prominently displaying the Fund's financial condition to decision-makers, (2) establishing a liability for potential future yearly losses on outstanding loan guarantees, and (3) preparing budget estimates that are based on MARAD's most recent experience with default payoffs.

See comment 7

D. Administrative and Accounting Systems

GAO found that the internal control weaknesses discussed in their draft report are material and warrant their inclusion in the Secretary of Transportation's 1986 annual statement under the requirements of the Federal Manager's Financial Integrity Act of 1982.

GAO recommended that the Secretary of Transportation include the material weaknesses identified in MARAD's Federal Ship Financing Guarantee Program in her 1986 annual statement on internal controls to the President and the Congress. The weaknesses should be reported in future years until the Secretary determines that the corrective actions taken are sufficient to preclude further inclusion.

III. SUMMARY OF DEPARTMENT OF TRANSPORTATION POSITION:

A. Loan Portfolio and Status of Federal Ship Financing Fund

The Department agrees that a significant proportion of the Federal Ship Financing Guarantee (Title XI) program loan portfolio is troubled. We also agree with the fact that revenues to the Federal Ship Financing Fund are currently not sufficient to cover all expenses including defaults. These specific problems, as well as others, are currently being addressed by an Office of Management and Budget, Department of the Treasury, Office of the Secretary, and MARAD Task Force. This Task Force is analyzing the problems and determining alternative solutions.

See comment 8 B. Program Data

The Department disagrees with GAO's conclusions for the following reasons:

1. Two different financial reports covering the same period were prepared for different purposes, and therefore did not display the same information.

2. Although a single list of troubled companies did not exist, program officials had updated information on all troubled companies.

C. Accounting Documents/Financial Statements and Default Estimates

The Department does not agree with some of the GAO conclusions for the following reasons:

See comment 3 1. MARAD's FY 1985 financial statements for the Title XI program reported that expenses exceeded revenues by $250,826,636.

See comment 7 2. MARAD received and implemented GAO guidance to disclose the contingent liability with a footnote to the FY 1986 financial statements.

See comment 9 3. The Inspector General's report was not critical of MARAD's accounting for receivables or Allowance for Losses.

See comment 10 The Department agrees with GAO that our budget
submissions underestimated likely defaults, but the
report should reflect that these estimates were made
See comment 7 8-20 months before completion of the period during which
the defaults occurred. The Department does not agree

with GAO's proposed method for estimating future defaults, for it relies solely on historical data and does not consider future economic conditions.

See comment 7

D. Administrative and Accounting Systems

The Department does not agree with GAO's conclusions that material weaknesses exist in MARAD's administrative and accounting systems for the following reasons:

1. As earlier noted, GAO compared two different financial reports for the same period that were prepared for different reporting purposes.

2. Program officials had information on all troubled companies, even though one single listing did not exist.

3. As noted earlier, the Fund's financial statements clearly disclosed that expenses exceeded revenues.

4. MARAD followed GAO's guidance by disclosing the contingent liability with a footnote to the FY 1986 financial statements.

IV. DEPARTMENT OF TRANSPORTATION POSITION STATEMENT:

A. Loan Portfolio and Status of Federal Ship Financing Fund

1. GAO found that about one-quarter of the value of the loan portfolio as of March 1986 was troubled, 28 percent of loan guarantees were troubled, 37 percent of the vessels covered were troubled, and 22 percent of the companies with a loan guarantee were troubled.

   GAO also found that the Fund's expenses exceeded its revenues. The Fund had a surplus of about $63 million in FY 1982, but had a deficit of $250 million by the end of FY 1985. In FY 1986, default payments reached $1.2 billion by July 1986.

2. The Department agrees that there are problems. These specific problems, as well as others, are currently being addressed by an Office of Management and Budget, Department of the Treasury, Office of the Secretary, and MARAD Task Force. This Task Force is analyzing the problems and determining alternative solutions.

   The Department does not dispute that a significant proportion of the Federal Ship Financing Guarantee program portfolio is troubled, no matter what measure is used. As the GAO draft report states, defaults have increased over the past three years, largely because of economic conditions, including (1) a worldwide shipping recession, (2) a reduced demand in domestic waterborne shipping reflecting significant shifts in international trade, and (3) a downturn in the energy industry (not just the offshore drilling industry, as stated on page 16 of the draft report).

See comment 11

   The Department also does not dispute the statement that revenues to the Federal Ship Financing Fund are not presently sufficient to cover defaults. The statement does reflect the status of program cash flow. However, revenues to the Fund are sufficient to cover administrative and custodial expenses. Revenues are not sufficient to cover default payments, and as authorized by statute, MARAD has borrowed from the U.S. Treasury to fund default payoffs. MARAD has made all required payments on the Treasury borrowings. Therefore, rather than use the words insolvent or insolvency throughout the draft report, we suggest more accurate wording such as "presently operating at a deficit." It should also be pointed out that the current problem facing the Fund may well prove to be temporary. The proposed supplemental appropriation and recoveries from sales of defaulted vessels could eliminate the problem.

See comment 12

In order to clarify program history in the report, we believe the several references to the 15-year history of guaranteeing loans should be revised to make it clear that the Title XI program has been in operation for close to 40 years. The program was authorized in 1938, with the first transactions made in the 1950's. Under the Federal Ship Financing Act of 1972, the program was amended so that, rather than insuring a loan or mortgage agreement, the United States now directly guarantees the payment of principal and interest on obligations.

B. Program Data

1. GAO concluded that MARAD could not readily provide accurate data on the total value of outstanding loan guarantees and commitments, and that MARAD did not have a complete list of troubled companies. GAO found that the data provided to them by MARAD on outstanding loan guarantees and commitments were inconsistent. Also, GAO initially reviewed data provided by MARAD on 44 troubled companies as of November 1985, but subsequently found that 14 additional companies were also troubled at that time and should have been on the original list.

   GAO recommended that the Secretary of Transportation direct the Maritime Administrator to compile reliable data on the total value of outstanding loan guarantees and commitments and the portion of the loan guarantee portfolio that is considered to be troubled.

See comment 8

Now on p. 21

2. The Department does not agree that MARAD could not readily provide accurate data on the total value of outstanding loan guarantees and commitments. MARAD does have accurate information on its loan portfolio. Reports are prepared monthly identifying the amount of the outstanding loan balance and commitments. The updating of this monthly report is not as stated in the first full paragraph on page 24, and should be reworded as follows: "The outstanding loan balance for each contract is updated as information is received by MARAD's Office of Accounting from Indenture Trustees. This Office then compiles monthly reports of loan balances and commitments. The Office of Ship Financing used these monthly reports

to prepare semiannual reports at the end of March and September on the total value of outstanding loan guarantees and commitments."

Now on p. 21

Now on p. 21

The evidence used by GAO to support its contention that MARAD could not readily provide accurate data on the total value of outstanding loan guarantees and commitments is based on information contained in MARAD financial statements, reports, and testimony prepared for the period between March and September of 1985. On page 24, lines 19-22, the $0.2 billion difference between the two reports of September 30, 1985, is essentially the estimated amount of accrued interest (approximately $186 million) that was clearly included as a separate entry in the report to Treasury (as required by GAO accounting principles and standards, and Treasury reporting requirements) but not included in the semiannual program report (where accruals are not required) of outstanding principal balances for contracts in force. The presentations of September 20, 1985, and June 25, 1985, discussed on pages 24-25, clearly should have indicated that the $6.9 billion represented the total of guarantees and commitments as of March 31, 1985, as it appeared in the most recent semiannual report. In general, MARAD presentations do contain adequate explanations. However, to avoid any possible confusion, all future reports and presentations will include qualifying explanations and footnotes as appropriate.

See comment 13

While MARAD did not provide a single complete list of troubled companies, information on all companies considered to be troubled is readily available. MARAD prepares a complete risk analysis of its portfolio periodically, with a three-part numerical ranking system based on whether the risk of default is considered minimal, moderate, or high. Additionally, MARAD prepares a monthly Credit Watch report for senior Agency officials. Copies of this report are/have been provided to the Office of the Secretary of Transportation. The list of troubled companies in the monthly Credit Watch report, a copy of which was provided to GAO, was never intended to be a comprehensive listing of all troubled companies. This report is limited to detailed information and status reports on troubled companies with payments currently due. Liner companies are generally excluded from the Credit Watch report, as are other companies which do not have payments due but which show signs of problems. Information on these latter companies is available from special reports prepared separately by MARAD as developments warrant. A single report specifically addressing all troubled companies may be a useful mechanism for consolidating information for management. However, the risk analysis, the detailed individual company analyses and the Credit Watch report do make information on all troubled companies available to senior management officials. Nevertheless, MARAD is in the process of reestablishing procedures to produce a single complete list of troubled companies to address GAO's concern.

In specific reference to the November 1985 period cited in the GAO draft report, MARAD considered 58 companies to be troubled. Of these companies, 44 were included in the Credit Watch report with information on the remaining 14 being provided to senior officials in separate reports and analyses prepared by MARAD staff.

See comment 14

Now on p. 23

The statement in the last sentence on page 21 of the draft report that MARAD had not analyzed the entire loan guarantee portfolio to determine whether the lists of troubled companies contained all the troubled companies as of the dates in question is not correct. MARAD did and currently does analyze the entire portfolio in determining which companies are troubled.

See comment 8

The Department believes the GAO recommendation concerning compilation of reliable data is unwarranted. MARAD has always and will continue to compile reliable data on the individual and total value of outstanding loan guarantees and commitments and the portion of the loan guarantee portfolio that is considered to be troubled. MARAD is eliminating duplication in reports that contain data regarding the total value of guarantees and commitments. As noted above, MARAD also is reestablishing procedures to produce a single complete list of troubled companies. An automated system previously developed by MARAD is being modified and will have the capability to produce such a single list. These measures should insure that complete information is clearly presented in external and internal reports and in testimony and should mitigate potential misunderstandings.

C. Accounting Documents/Financial Statements and Default Estimates

See comment 3

1. Financial Statements Did Not Disclose Insolvency.

a. GAO found two problems with the fund's fiscal year 1985 annual statement of financial condition, one related to the fund's revenues and expenses, the other related to the fund's assets and liabilities. Specifically, GAO states that it was not shown that expenses exceeded revenues, and that this was not reflected in the statement of financial condition.

b. It is not known if GAO is criticizing MARAD in this section for (1) not establishing a liability, but instead using footnote disclosure, or (2) not showing that expenses (including defaults) exceeded revenues. If GAO believes an accrual is necessary, please see response 2b below. If GAO believes that the financial statements did not show that expenses (including defaults) exceeded revenues, we do not agree.

It should be understood that MARAD '85, the Annual Report of the Maritime Administration for Fiscal Year 1985, is a consolidated financial statement for all MARAD programs. Although it does not contain only Federal Ship Financing Fund financial information, it did disclose that the Fund's FY 1985 expenses exceeded revenues by $250,826,636 in the Statement of Operations on page 52.

The MARAD '85 also reported on page 51 that during FY 1985 MARAD borrowed $130 million from the U.S. Treasury to meet demands for payments due on defaults, another clear indication that the program is operating at a deficit.

The FY 1985 operating deficit also was reflected in the Statement of Income and Retained Earnings (Standard Form 221) included as part of the Statement of Financial Condition submitted to Treasury. The titles of the financial statements submitted to Treasury were changed for Fiscal Year 1986 reports. However, the Report on Operations (Schedule 221), included as part of the Report on Financial Position, clearly shows an operating deficit of $754,963,674 for FY 1986.

Copies of this FY 1986 financial report have been provided to GAO. The FY 1986 deficit also will be reported in MARAD '86.

See comment 7

2. Failure To Accrue Contingent Liability.

   a. GAO states that the Department failed to accrue a contingent liability for potential future guaranteed loan losses. GAO cites the accounting standard "that reasonable and probable losses on guarantees, loans, and other assets be recognized in accounting statements if the amount can be reasonably estimated."

   b. In July 1986, MARAD accounting officials met with the GAO Director of Accounting and Financial Management, and agreed that although losses were "probable" they could not be "reasonably" estimated. Therefore, footnote disclosure would be adequate. It was acknowledged at this meeting that using the "best guess," should it be significantly in error, would unacceptably distort the Statement of Operations. As a result of this meeting, MARAD included a footnote in the FY 86 financial statements that estimated defaults on guaranteed loans to be $250,000,000. This estimate was changed to approximately $600 million in January 1987 when new information became available.

See comments 9 and 15

3. Inspector General Report on Similar Weakness

   a. GAO stated that the Inspector General (IG) report found that:

      1. MARAD carried all of its $106 million in loans (advances) to troubled companies as assets when only 50 percent of the advances were likely to be collected.

      2. MARAD should not continue to list all of the advances as collectible because such a decision could affect budgetary decisions.

   b. It appears that GAO is stating that our IG recommended that we write off receivables in which there has not been default. In discussions with our IG auditors, they stated that:

1. The IG audit report does not refer to receivables on MARAD's books, but rather those of the U.S. Treasury. It states on page 14 that..."Showing a receivable on the books of the Treasury indicates that the FSFF will eventually recover and repay the loan to Treasury. However, since the fund will unlikely ever repay the Treasury, continuing to carry a receivable could affect budgetary management decisions."

2. The IG's audit report does not address "Allowance for Losses."

4. MARAD's Budget Underestimated Likely Defaults

a. GAO stated that MARAD's budget underestimated likely defaults.

b. The Department concurs that MARAD's budget submissions have underestimated actual defaults in the past. Part of the problem, as discussed in more detail below, has been that economic projections did not accurately reflect what happened in the oil market in late 1985 and 1986. However, we also agree with GAO that the methodology used to estimate the defaults has tended to result in underestimating actual defaults. An interagency Task Force is currently analyzing the methodology to determine what improvements can be made.

Although the Department concurs that MARAD's budget submissions underestimated actual defaults, we would appreciate the report reflecting that MARAD officials apprised the Congress in June 1985 testimony that the projected number of defaults had increased after the February 1985 budget submission. It should also be reflected in the report that at the time the estimates were made many of the actual defaults were not considered probable. To reach the conclusion that the budget submissions were underestimated, GAO compared the levels included in the proposed budgets dated February of 1985 and 1986 with actual results for FY 1986. In developing the estimates, MARAD used information from respected economic sources which forecasted stabilization in the oil market. Contrary to these forecasts, depression in oil prices continued and ultimately contributed directly to the higher than predicted level of actual defaults. It is not unusual, especially in today's rapidly changing maritime economic environment, for forecasts to vary significantly from actual results. This especially is true for estimates presented in the President's budget which are prepared 8-20 months ahead of the relevant time period. The difficulty in forecasting is also recognized by GAO, as evidenced in the statement on page 35 of the report, "...we recognize that such estimates are imprecise because of the difficulties of anticipating future economic conditions and industry developments."

Now on pp. 29-30

See comment 7

While the methodology for projecting defaults could be improved, the Department disagrees that the GAO technique, which uses only the rate of default among troubled companies in a given year to predict defaults in the subsequent year, is a more realistic approach to developing budget estimates. Rather, we believe it is more realistic to develop estimates by analyzing several factors, including historical data, for each element of the portfolio. In proposing its method, even GAO recognizes that estimates using historical defaults are imprecise. Given this caveat, the argument for selecting a method different than that used by MARAD is not convincing. The GAO approach certainly would not have predicted the large increase in defaults between 1985 and 1986.

See comment 7

D. Administrative and Accounting Systems

1. Material internal control weaknesses not included in Annual Statement.

    a. GAO states that the following four material internal control weaknesses existed and were not reported.

        1. Program did not have routinely accurate data on the value of the portfolio.

        2. Program did not have a complete list of troubled companies.

        3. Fund's financial statements and other documents did not clearly disclose the fund's insolvency.

4. MARAD did not establish a liability for potential future losses on loan guarantees.

b. The Department has the following comments on the purported weaknesses:

1. No weakness existed. See Program Data, B, 2.

2. We do not believe that not having one single list of troubled companies constitutes a material weakness. See Program Data, B, 2.

3. No material weakness existed. Informal GAO guidance was followed. See Accounting Documents/Financial Statements and Default Estimates, C, 1 and 2.

4. See 3 above.

Even if we did determine that there were internal control weaknesses when GAO provided the draft report on December 24, 1986, it is unrealistic for GAO to expect that the weaknesses would be included in the Secretary's 1986 letter. This letter is prepared much earlier than December 24 so that it can be properly coordinated throughout the Department in order to assure that the report is accurate. If changes were made to the report after the coordination process, there would be a breakdown of the internal control procedures we have in place to assure the report's accuracy.

2. Program Meets Factors of Materiality

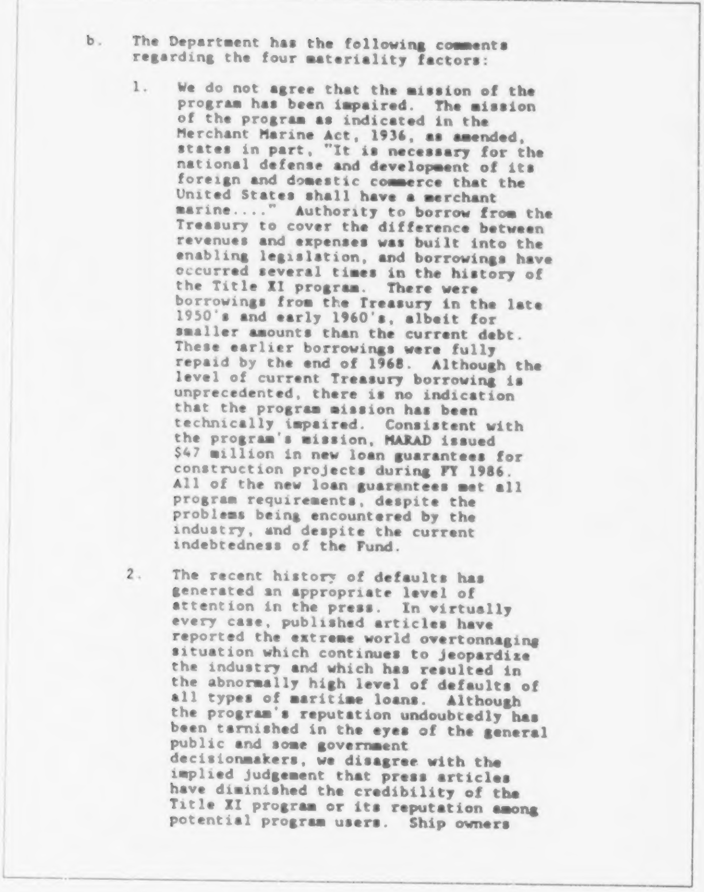
a. GAO states that the program meets the following four materiality factors:

1. The program mission has been impaired.

2. The program reputation has been diminished.

3. Secretary needs to be involved in the issue.

4. MARAD violated a Comptroller General standard which possibly hampered Congress from fulfilling their oversight and budget responsibilities.



b. The Department has the following comments regarding the four materiality factors:

1. We do not agree that the mission of the program has been impaired. The mission of the program as indicated in the Merchant Marine Act, 1936, as amended, states in part, "It is necessary for the national defense and development of its foreign and domestic commerce that the United States shall have a merchant marine...." Authority to borrow from the Treasury to cover the difference between revenues and expenses was built into the enabling legislation, and borrowings have occurred several times in the history of the Title XI program. There were borrowings from the Treasury in the late 1950's and early 1960's, albeit for smaller amounts than the current debt. These earlier borrowings were fully repaid by the end of 1968. Although the level of current Treasury borrowing is unprecedented, there is no indication that the program mission has been technically impaired. Consistent with the program's mission, MARAD issued $47 million in new loan guarantees for construction projects during FY 1986. All of the new loan guarantees met all program requirements, despite the problems being encountered by the industry, and despite the current indebtedness of the Fund.

2. The recent history of defaults has generated an appropriate level of attention in the press. In virtually every case, published articles have reported the extreme world overtonnaging situation which continues to jeopardize the industry and which has resulted in the abnormally high level of defaults of all types of maritime loans. Although the program's reputation undoubtedly has been tarnished in the eyes of the general public and some government decisionmakers, we disagree with the implied judgement that press articles have diminished the credibility of the Title XI program or its reputation among potential program users. Ship owners

have continued to seek Title XI guarantees, and bond purchasers have continued to participate in the program.

3. We believe the assertion regarding the lack of personal attention or awareness of the agency head or higher management has been seriously misconstrued in its application to the Title XI program. The Secretary of Transportation has regularly been provided briefings by the current and former Administrator on the Fund and industry status. The Secretary, in recognition of the difficulties faced in bankruptcy situations, was personally involved in successful efforts to amend bankruptcy laws and hasten the Government's ability to move against defaulted assets. In addition to those instances cited above, the Secretary actively advocated a supplemental appropriation to pay off the principal and interest on Treasury borrowing in discussions with OMB on the FY 1988 budget. We believe these efforts reflect that the Secretary has appropriately focused her attention on major programmatic issues and the consequences of those conditions relative to the status of the Fund and other government operations. However, the internal control weaknesses cited by GAO, and summarized on pages 41 and 42 of the draft report, involve administrative matters and accounting reports. We fail to see how the GAO concludes that the program meets this materiality factor "because of these weaknesses." In the discussion of this materiality factor, the GAO draft report makes no reference to these "weaknesses." Instead, the report notes that the large number of defaults, the inability to cover default payoffs from the Fund balance, and the debt to the Treasury, warrant involvement by the Secretary. We certainly agree that these are problems which require personal attention by the Secretary, but these are not the internal control weaknesses that were cited by GAO.

To reiterate, we are particularly concerned with statements which imply that the Secretary of Transportation has not been aware of or involved in the problems resulting from the large number of default payoffs and the inability to generate sufficient revenues to cover the default payoffs and repay debt to the Treasury. The Secretary has been fully aware of changes in the condition of the Fund and the industry.

4. Comptroller General Standard not violated. See response to Accounting Documents/Financial Statements and Default Estimates, C, 2, b.

   We also are concerned with the implication that MARAD and the Department have been misleading Congress as to the status of the Title XI program and its present default problems. MARAD has responded to Congressional inquiries with data that accurately portray the program's status. As discussed earlier, MARAD financial statements clearly did disclose that the program was operating at a deficit and did identify the indebtedness of the Fund. Estimates of defaults were included in budgets submitted to Congress, although these estimates ultimately proved to be low.

3. The Inspector General Found Internal Control Weaknesses

   a. GAO states that the Inspector General found the following internal control weaknesses:

      1. MARAD carried all of its $106 in loans to troubled companies as assets when only 50 percent of the loans were likely to be collected.

      2. MARAD used revenue from insurance proceeds to convert two defective vessels rather than selling or scrapping them.

      3. MARAD lacked documented pertinent information concerning available alternatives and their related costs in 21 instances where companies were allowed to revise the terms of their loans to facilitate repayment. It also stated that 11 of these companies have defaulted, and 8 more probably will in the next 3 years.

b. Although the IG report never mentioned the term "internal control weaknesses," the Department has the following comments on GAO's interpretation of the information provided in the report:

1. Considering that there was an Allowance for Losses of $61.4 million for these loans on September 30, 1985, we are unable to determine what internal control weakness GAO is citing.

2. Since top management was aware of the risks being assumed when deciding to proceed with the project, and the use of the funds in this manner was permissable, it is the Department's opinion that no internal control weakness existed.

3. GAO appears to be drawing the conclusion that because there were 21 workouts, and it appears that 19 will result in defaults, there was an internal control weakness. There is no presentation in the draft report which demonstrates that the actions taken were more costly to the Government than other alternatives. The primary consideration in approving a workout is that the Government would be no worse off, considering all relevant costs, than if the workout was not approved. In addition, in these circumstances, the agency is fulfilling its program role by allowing the debtor an opportunity to rehabilitate itself during economic distress. The IG report recommended that the cost analyses of alternatives be better documented.

It should also be noted in the report that the IG reviewed MARAD's response to that audit report and concluded on December 10, 1986, that the actions taken or planned by MARAD are considered responsive to the recommendations in the report. The IG considers the audit report closed.

See comment 16

E. We would appreciate it if the following editorial corrections were made in the report.

Page	Correction
2	In "Background," the fees are set by MARAD in accordance with statutory limitations.

Now on p. 8.	2	The limitation is on "the principal amount of guaranteed loans and commitments in force," not on "loans."
Now on p. 8.	3	The annual limits on new guarantees (not "loans") have only occurred in recent years.
See comment 17 Deleted from final report	5	The September 30, 1986, financial statements included a contingent liability footnote for potential defaults, so the contingent liability had been established in December 1986.
	10	In the second paragraph, the first sentence should read: "Funds for vessel construction are obtained by the ship owner through the issuance of corporate bonds which are sold to private sector investors, such as banks, pension trusts, and life insurance companies, as well as to the general public."
	11	In the first paragraph, in (1) add "in accordance with statutory limitations" after "MARAD," and at the end of the first sentence, add "and (4) repayment of Federal loans."
See comment 18 Now on p. 8.	11	In the second paragraph, in the first sentence replace "private sector lender" with "Indenture Trustee on behalf of the bondholder or the bondholders themselves."
See comment 11 Now on p. 9. Now on p. 12 only.	16	In the first paragraph, the expenses covered by Treasury borrowings are those related directly to default payoffs. Fund revenues are sufficient to cover other expenses. The same comment pertains to the final paragraph on page 17, and the first paragraph on page 43.
Now on p. 20.	22	In the footnote, delete the second sentence in view of the fact that both commitments and guarantees may be based on either estimated or actual costs.
Now on p. 30.	35	In the third paragraph, second sentence, add ", generally companies with newer high cost equipment in depressed industries," after "the weaker companies."

The following are GAO's comments on the Department of Transportation's letter dated April 7, 1987.

GAO Comments

1. We have provided updated information on the troubled portion of the portfolio as of September 30, 1986.

2. We noted that fiscal year 1984 was the last year the fund's revenues exceeded expenses. We also updated fiscal year default payments through September 30, 1986.

3. Discussed in the agency comments section of chapter 2.

4. We updated fiscal year 1986 default payments through September 30, 1986, and deleted Marad's estimate of default payments for the remainder of the fiscal year ($200 million).

5. Marad's original estimate of $100 million is not included in our final report.

6. Discussed in the agency comments sections of chapters 2 and 4.

7. Discussed in the agency comments section of chapter 4.

8. Discussed in the agency comments section of chapter 3.

9. Our report did not address allowance for losses.

As stated in our report, the Office of Inspector General report recommended that Marad make annual projections of fund revenues and expenses and request appropriations for any anticipated shortfalls.

10. Discussed in agency comments section of chapter 4. Marad's year-end financial statements to the Treasury were not transmitted until December 30, 1986. We believe sufficient time was available to include the $600 million estimate since the Deputy Associate Administrator for Maritime Aids told us that both estimates were prepared during the same period. The fiscal year 1986 annual report was issued in June 1987.

11. Discussed in the agency comments section of chapter 2. The Federal Ship Financing Fund is a public enterprise revolving fund. This type of

fund is an expenditure account that is credited with collections, primarily from the public, generated and earmarked to finance a continuing cycle of business-type operations. That is, this fund receives fees primarily from shipowners to pay for expenses related to the continuing operation of the Federal Ship Financing Program. Default payments are included as an expense of operating the program. We believe this type of fund should not rely on Treasury borrowings to finance portions of its expense payments.

Our position is that public enterprise revolving funds may be appropriate when

- a continuing cycle of operations exists that generates receipts, principally from the public,
- the fund is or will likely be substantially self-sustaining, and
- a substantial need for flexibility exists to meet unforeseen requirements.

12. Prior to fiscal year 1973, Marad made default payments totaling about $37 million (or almost 2 percent) of the nearly $1.9 billion in default payments since the program's inception in 1936. Although default payments for insured loans or mortgages may have been made for vessels after fiscal year 1973, the vast majority of default payments were for guaranteed loans. These loan guarantees were approved after fiscal year 1972.

13. Discussed in agency comments section of chapter 3. Additionally, Marad officials told us in January 1987 that the automated system that produces the ranking for each company in its portfolio was not fully operational and that information on the financial status of companies is updated every 6 months. They said that reliable and useful reports will be available in February 1987. We met with the Deputy Associate Administrator for Maritime Aids on February 27, 1987, who said that the system was still not fully operational, but that he would provide a copy of the report when it was. The system was not operational in July 1987 and, consequently, we were not provided a copy of the report.

Marad officials told us that they did not prepare credit watch reports for January 1986, August 1986, and April 1987. They also were unable to provide copies of the report for the 10-month period between January 1985 and November 1985. Further, the March 1987 credit watch report listed the liner companies' names only with little additional information on their title XI loan guarantees.

14. When we stated that neither Marad nor GAO analyzed the entire loan portfolio to determine whether the November 1985 and June 1986 lists were complete, we meant that Marad officials said they did not document the process for preparing a complete list of troubled companies. Therefore, we could not verify that the entire portfolio had been reviewed, and Marad program managers could not verify that all companies' circumstances had been reviewed thoroughly and consistently.

15. The Office of Inspector General report stated on page 5 that "Marad recorded receivables of $106 million in its accounting records as of December 31, 1985."

The report also states on page 14 that "Title XI advances are recorded [on the Treasury Department books] as an interdepartmental receivable."

16. Except where otherwise noted, we have made changes to incorporate DOT's editorial comments.

17. The financial statements were officially approved and transmitted to the Treasury Department on December 30, 1986.

18. "Private sector investors" is the generic phrase we used in this report.

Appendix II

Major Contributors to This Report

Resources, Community, and Economic Development Division, Washington, D.C.	Kenneth M. Mead, Associate Director, (202) 366-1743 David Marwick, Group Director Frank Bowers, Evaluator-in-Charge Robert W. MacFarlane, Evaluator
Accounting and Financial Management Division, Washington, D.C.	Dennis J. Duquette, Associate Director

OVERSIGHT ON THE REDUCTION IN U.S. SHIPBUILDING AND SHIP REPAIR CAPABILITY

TUESDAY, DECEMBER 8, 1987

House of Representatives,
Subcommittee on Merchant Marine,
Committee on Merchant Marine and Fisheries,
Washington, DC.

The subcommittee met, pursuant to notice, at 1:08 p.m., in room 1334, Longworth House Office Building, Hon. Glenn M. Anderson (acting chairman of the subcommittee) presiding.

Present: Representatives Anderson, Biaggi, Foglietta, Tallon, Bennett, Pickett, Dyson, Shumway, Bateman, Saxton, Miller, Bentley, and Coble. Representative Lowry of the Full Committee also attended.

Staff present: Subcommittee on Merchant Marine—Cynthia M. Wilkinson, chief counsel; Melanie Barber, counsel; Ann M. Mueller, clerk; Kip Robinson, minority counsel. Committee on Merchant Marine and Fisheries—John Cullather, staff assistant; George Pence, minority staff director; John Moran, minority counsel; Gwen Lockhart, chief minority clerk.

STATEMENT OF HON. GLENN M. ANDERSON, A U.S. REPRESENTATIVE FROM CALIFORNIA AND ACTING CHAIRMAN, SUBCOMMITTEE ON MERCHANT MARINE

Mr. Anderson. The meeting of the subcommittee will come to order.

This afternoon, the Subcommittee on Merchant Marine will take a close look at the alarming decline in the shipbuilding and the ship repair industry of our Nation.

Since colonial times, American leaders have recognized the importance of the ability to build and repair vessels in the United States. However, except in time of war or national emergency, Americans have been reluctant to devote the resources needed to insure the strength of the shipyard mobilization base. A viable shipyard industry is imperative. It is not simply an economic asset, but a national security asset as well. It is clear that, in order to meet many of our foreign policy objectives abroad, a healthy shipbuilding and ship repair industry is a necessity.

As the Bennett Commission recently pointed out in its findings, "Although the shipbuilding and ship repair industries would be able to meet the current surge phase requirements of a mobilization, the sustaining phase would be constrained by inadequate shipyard facilities, manpower, and material supplier capacity—both now and in the year 2000." Furthermore, this situation will only worsen unless Congress begins to address the problem.

Since 1982, over 52,500 production workers have lost their jobs because of shipyard closings or work force reductions in operating shipyards. The shipbuilding recession has hit the West and Gulf Coasts the hardest. At the beginning of 1987, 14,700 West Coast production workers were employed at 62 private shipyards, boat yards, and ship repair facilities. Just five years ago, 25,400 production workers were on the West Coast. The closing of 15 West Coast firms has resulted in the loss of 5,300 production worker jobs, as well as significant shipbuilding and repair capacity.

The number of managerial and production workers across the Nation, but especially on the West and Gulf Coasts, has fallen to critically low levels. When a managerial or production worker loses a job, the employee may leave the shipbuilding and repair industry, never to return. For example, the Shipbuilders Council reports that a shipyard won a Navy contract requiring the recall of 1,200 workers that had been laid off. Only 100 of the laid-off workers returned to the shipyard.

Some proponents of a strong national defense argue that ships and shipyards will not be needed in future wars. In 1945, a Harvard University report warned that "a prudent government . . . dares not take the risk of assuming now that such a condition will develop by the time it may again be called upon to defend the country in war." The warning is as timely today as when it was written more than 40 years ago.

I hope the testimony given today will further a strong national response to this serious problem.

Are there any other Members who would like to make opening statements? Mr. Biaggi?

STATEMENT OF HON. MARIO BIAGGI, A U.S. REPRESENTATIVE FROM NEW YORK AND VICE CHAIRMAN, COMMITTEE ON MERCHANT MARINE AND FISHERIES

Mr. Biaggi. Thank you, Mr. Chairman.

This hearing is designed to identify the forces that have weakened our ability to build and repair ships in this country and to explore proposals designed to strengthen the American shipbuilding and ship repair industry.

The United States needs a shipbuilding and ship repair capability that is sufficient to meet our commercial and military needs during peacetime and in the event of war or national emergency. The condition of our shipbuilding, ship repair, and ship supplier industries and the merchant marine work force is bleak. In the industry as a whole between 1982 and 1986, as the Chairman pointed out, there were some 52,500 jobs lost; 76 shipyards and ship repair facilities were closed; and 22 building ways, 17 floating dry docks, 21 graving docks, and numerous plant facilities were lost. In August 1987, at least 15 of the surviving firms were operating under Chapter 11 bankruptcy protection. Clearly, these statistics paint a disastrous picture for the industry and for the Nation.

The long-term problem with losing shipyards and facilities is that, once they are converted to more profitable uses such as upscale housing and recreational marinas, the cost of returning the waterfront property to shipbuilding and repair is prohibitive, if it can be done at all.

One of the main reasons for the industry's decline is that we are not building any commercial ships in this country. Naval ship construction and repair are virtually all that remain for the industry. Commercial ships are not being ordered because of a worldwide surplus of shipyards and merchant ships, the United States' inability to compete in terms of price with most foreign shipyards, little coastal or inland maritime work, the offshore energy industry's collapse, and the construction-differential subsidy (CDS) program's failure.

Shipbuilding has tended to follow low-cost labor, and foreign shipbuilding firms, especially in the Far East, have had the advantage of low-cost indigenous labor and cheaper materials. They also receive substantial support from their governments through tax incentives and direct subsidies.

Further exacerbating our national security problem is the fact that Europe's shipbuilders are in trouble. What was initially thought to be a temporary problem of cyclical demand increasingly looks like a fundamental structural crisis with no easy solution at hand. Our NATO allies' problem is our problem, since a major part of our military strategy in time of national emergency or war seems to be that, if our shipyards cannot produce enough ships, then we will procure vessels built by our NATO allies.

The Commission on Merchant Marine and Defense recently concluded that the shipbuilding, ship repair, and attendant industries have a valuable role to play in our national security and that the Federal Government needs to "revise our national objectives, policies and commitments" in order to turn this situation around.

The Commission's report is excellent. It echoes what we on this Subcommittee have been saying for years. Our shipyards are in trouble. In order to reverse this disastrous trend, we are going to have to take drastic measures. It will take a coalition of industry, labor, the Administration, and the Congress. It will not be an easy task, but we in the maritime world have never walked away from the battle. The difficulty of the challenge will make victory all the sweeter.

I mentioned a number of people who should be involved in this coordinated effort. Unless Congress and the Government get back into this business with the same kind of commitment they had during the Nixon years, it will continue to go down the drain. The present policy must be radically altered. Otherwise, with all due respect, the efforts of this Committee will be an exercise in futility.

I look forward to hearing all the witnesses today, Mr. Chairman.

Mr. ANDERSON. Thank you, Mr. Biaggi.

Mr. Saxton?

Mr. SAXTON. Thank you, Mr. Chairman.

First may I ask unanimous consent that opening statements for Mr. Davis and Mr. Lent be included in the record?

Mr. ANDERSON. No objection, so ordered.

[The prepared statements of Mr. Lent and Mr. Davis follow:]

STATEMENT OF HON. NORMAN F. LENT, A U.S. REPRESENTATIVE FROM NEW YORK AND RANKING MINORITY MEMBER, SUBCOMMITTEE ON MERCHANT MARINE

Mr. Chairman, once again we find ourselves holding a hearing to assess the plight of the American shipbuilding industry and to look at how, and why, this part of our maritime industry has declined. This situation is not new, and yet it is becoming more and more serious.

We now have another report—the first report of the Commission on Merchant Marine and Defense—that sets forth the findings of fact and conclusions from this Presidential Commission. This Commission highlights what most of us have known to be the case, that our American shipbuilding industry has suffered an enormous decline in the past ten years and it is time for the United States Government to reassess its priorities with regard to this industry. The data generated by this Commission will be very useful to all of us who are concerned with the need to have a healthy maritime industry. The shipyard mobilization base is just one part of what is necessary for a national program to support our commercial and military sealift needs.

As I indicated, I think most of the Members of this Subcommittee are aware of the condition of the American shipbuilding industry, but what we do not have at this time is a reasonable answer as to how to solve the problem of the continuing decline of this industry.

I hope that our witnesses today, both governmental and from the private sector, will focus their time and attention on addressing reasonable legislative proposals that would assist in revitalizing this important part of our industrial infrastructure.

Mr. Chairman, I look forward to hearing our witnesses and hope that we will be able to respond affirmatively as we prepare our legislative agenda for the next Session of Congress.

STATEMENT OF HON. ROBERT W. DAVIS, A U.S. REPRESENTATIVE FROM MICHIGAN AND RANKING MINORITY MEMBER, COMMITTEE ON MERCHANT MARINE AND FISHERIES

Thank you, Mr. Chairman. I commend you and the Members of the Subcommittee on Merchant Marine for holding this hearing today. It comes as no surprise to the Members of the Committee on Merchant Marine and Fisheries that our domestic shipbuilding and ship repair industry in this country is in critical condition. For years we have watched the demand for our domestic yards to build and repair merchant ships erode until this year, for the first time, there are no private commercial vessels being built in U.S. yards.

The reasons for this decline are complex. These include: the huge surplus fleet of merchant vessels on hand at the end of World War II dampened demand for domestic commercial construction for many years; the failure until recently of the domestic yards to invest in modern capital improvements and means of production; the shift of modern shipbuilding to developing nations with lower labor costs and massive government assistance programs to encourage shipbuilding; the surplus of merchant ships of all types leading to depressed freight rates and little incentive to invest capital required to purchase new vessels. Finally, we must acknowledge the failure of our government programs and policies to maintain a domestic shipbuilding base in light of all of the factors listed above.

The shipyard and ship repair industries play a vital national security role. For reasons of both preparedness and deterrence, this nation must be prepared for wars it hopes will never be fought. It is accepted fact that in time of mobilization over ninety percent of the materiels and supplies to support a sustained military effort will have to be transported by sea. Once lost, this nation cannot easily or quickly replace the expertise, capital investment, physical facilities, and suppliers that make up our shipbuilding and ship repair base.

I am heartened by the Commission on Merchant Marine and Defense recently issued "Findings of Fact and Conclusions". The Commission recognized that our shipyards, repair facilities, and their industrial suppliers are inadequate to meet our current national security requirements and are continuing to deteriorate at an alarmingly progressive rate. The Commission concluded that, "[T]he shipbuilding mobilization base must be maintained to ensure that the demands of the national strategy can be met". Most importantly, the Commission recognized that the situation can only be addressed with the commitment of national resources to pay for the defense portions of the maritime industries. Once this fact is recognized and acknowledged, the Congress and the Administration can realistically begin to fashion an effective course of action to correct the problem.

Any solution to assure an adequate sealift and shipyard mobilization base will require money and hard choices. Mr. Chairman, this is a timely hearing. On September 11, I introduced H.R. 3297, a bill "to amend the Merchant Marine Act, 1936, to establish a new system of operating-differential subsidy contracts for vessels in liner service, and for other purposes." Perhaps the most controversial provision of this bill is that it continues the requirement that vessels be constructed in the United States in order to be eligible for subsidy. At the time I introduced this bill, I realized that without more, this position was unrealistic. I know that, to survive in the competitive world of ocean transportation, U.S. ship operators must be able to acquire ships at something near world prices. However, discussions of operating-differential subsidy reform must be accompanied with parallel discussions of how to preserve the vital shipbuilding and ship repair base. Different sectors of the maritime industry may be treated for some purposes, but overall national security requires that the maritime industry be viewed as a whole.

I welcome the hearing today. It is a first step towards not just defining the problem, but starting to shape possible solutions to the shipbuilding problem. I hope these possible solutions will be explored more fully in the days ahead. I would like to welcome the witnesses, and I look forward to hearing their testimony.

STATEMENT OF HON. JIM SAXTON, A U.S. REPRESENTATIVE FROM NEW JERSEY

Mr. SAXTON. Mr. Chairman, I am particularly grateful to you for calling this hearing today. It is one that I have looked forward to for some time.

I think most of the members of this Committee are all too familiar with the grim realities that have been pointed out by you, Mr. Chairman, and by Mr. Biaggi. For example, in addition to what you said, I think it is interesting to point out that the operating U.S.-flag merchant marine declined from an incredible 2,114 active merchant ships in June of 1947 to somewhere in the neighborhood of 370 active ships as of January at the beginning of this year. This, coupled with the simultaneous decline in shipyards, has brought us to a very critical situation—one in which we find ourselves with labor rates being too high, laws too restrictive, construction facilities too old, and lack of subsidies that are abundant in shipbuilding countries around the world.

The decline of the merchant marine has been continuous during the last several decades in spite of the Federal support programs that we have had such as construction-differential subsidy (CDS), the operating-differential subsidy (ODS), capital construction fund (CCF), title XI guarantees, and reservation of 50 percent or more of government-impelled cargoes for transport on United States-flag ships.

The U.S. Department of Transportation has submitted to Congress legislation to implement the Administration's proposed reform of the ship operating-differential subsidy program. The Administration hopes that these reforms would enable U.S.-flag operators to compete more effectively with their foreign counterparts.

However, it seems fairly clear that part of the proposal, specifically the section authorizing worldwide acquisition of vessels, must be submitted to very close scrutiny because of the potential long-term effect on the shipbuilding industry in our country. It is my hope that we will be able to hear testimony about this legislation and something that we will be able to benefit from; and, as Mr. Biaggi suggests, take action in the months ahead.

I would also like to take this opportunity to commend the Commission on Merchant Marine and Defense for their findings in their first report to Congress. And I look forward to their final report complete with legislative proposals due out, as I understand it, around the first of the coming year.

Although the Commission addressed itself to defense aspects alone, they have found that "the maritime industries, including the merchant marine, are and will be for the foreseeable future an essential component of America's national security capability."

Therefore, I feel we should look into how we can construct new ships to be militarily useful and operating, used for commercial cargo during peacetime and manned by United States crews.

Again, Mr. Chairman, let me thank you for calling this hearing today.

Mr. ANDERSON. Thank you, Mr. Saxton.

Mr. Lowry?

STATEMENT OF HON. MIKE LOWRY, A U.S. REPRESENTATIVE FROM WASHINGTON AND CHAIRMAN, SUBCOMMITTEE ON OCEANOGRAPHY

Mr. LOWRY. Mr. Chairman, I would like to ask unanimous consent that my statement be placed into the record.

Mr. ANDERSON. Your prepared statement will appear in the record immediately following your oral presentation.

Mr. LOWRY. I also would like to add my appreciation for your calling the hearing today. I know that there was some interest in waiting until the recommendations of the Commission on Merchant Marine and Defense had been made before scheduling this hearing, but many of us thought it would be good to address some of these critical issues. And then, of course, under your and Mr. Biaggi's leadership, I will know the Committee will be looking to follow up at the proper time after the recommendations are out.

In addition to the comments that were made previously, I would like to point out the importance of this hearing in taking a look at the bid process relationship to the demise of the shipyards. I believe the Navy's bid process directly contributes to problems faced by shipyards, including their rapid decline.

We have the General Accounting Office study before us that says Navy contracts are consistently being let under the estimates the Navy says the ships can be built for. And then, at the same time, we are sitting here looking at this tremendous demise in the shipyards. We have created a situation where it is almost impossible to survive under our bid process, and then we sit here and say, gee, I wonder how come we have had this tremendous demise in the shipyards.

And then, of course, we know from the Commission and other information, about the relationship between our Merchant Marine and shipyards to national security. Our shipbuilding capacity is very important. So, obviously looking at the way that the bid process works is critical given the situation we have ourselves in.

Secondly on that, Mr. Chairman, I think we have also learned from experience that the real cost of a ship to the Government over the years is not necessarily reflected in the initial bid to get the shipbuilding contract. The quality of the work and thereby then, the amount of repair that has to be done to make up for poor quality, the underbids and having to come back in with cost re-estimates, add up into the real cost of the ship—over the lifetime of the ship—being significantly different than what the low bid process appears to initially indicate. And so, that's another very important issue that this Committee will be looking at and discussing, I hope, over the weeks.

Thank you, Mr. Chairman, for the opportunity for having this hearing.

[The prepared statement of Mr. Lowry follows:]

STATEMENT OF HON. MIKE LOWRY, A U.S. REPRESENTATIVE FROM WASHINGTON

My concerns about the problems plaguing the shipbuilding and ship repair business prompted me, along with my colleagues, Ms. Schneider, Mrs. Bentley, and Mr. Foglietta, to request a hearing to begin to address these problems. I would like to thank Chairman Anderson for scheduling this hearing and thank my colleagues for their interest.

The Commission on Merchant Marine and Defense found a clear and growing danger to our national security because of the deteriorating condition of our maritime industries, including the shipbuilding mobilization base. In less than 4 years, at least 27,000 jobs in shipyard production were lost due to the closure of shipyards. On the west coast, since 1982, the number of shipyard production workers has dropped by an alarming 51 percent. In addition, at least 15 shipyards are operating under chapter 11. Absent a dramatic turnaround, this decline is fully expected to continue.

Without question, the scarcity of U.S. merchant vessels and the lack of orders to build additional merchant vessels is a major factor contributing to the problems plaguing the U.S. shipbuilding and repair industry. Because of this fact, Government contracts for ship repair and shipbuilding are currently the primary source of business for U.S. shipbuilders. Therefore, Government contracting policies for shipbuilding and repair are having a significant effect on shipbuilding and may be contributing to additional declines in U.S. shipbuilding capabilities and our overall shipyard mobilization base.

For example, a recently completed GAO investigation on ship construction contracts found that the Navy consistently accepted bids at levels below which a shipbuilding project could be completed. Prices proposed on some contracts were identified by the Navy, at the time of the award, to be: (A) overly optimistic, (b) below Navy estimates, and (c) presenting a cost risk to the Government.

Recently reviewed awards indicate that the Navy is continuing this practice. This is especially disturbing when considering the need for a viable shipyard mobilization base for national security. The Navy, by consistently awarding contracts to shipyards at costs below whch a ship can be realistically constructed, creates an extremely competitive climate resulting in risks for shipbuilders and the potential demise of more shipyards. Although shipbuilders are aware of the risk posed by accepting a shipbuilding contract which will likely cost more to complete than the job will generate, many shipbuilders feel they have no choice but to compete for the few Navy jobs available just to keep their yards operating in hopes of better times in the future.

My fear is that these Navy practices may result in the closure of many more first-class facilities and further erode our shipyard mobilization base. We cannot allow misguided policy to result in further erosion of our basic shipbuilding capabilities.

Through this hearing I hope we are able to identify problem areas within the shipbuilding and repair industries and establish whether Government policies are negatively affecting this nationally strategic industry.

I wish to thank GAO for their comprehensive work in studying cost overruns, and claims potential on Navy shipbuilding contracts, and for their willingness to testify before us today. The study was requested of GAO by the House Appropriations Subcommittee on Defense.

Additionally, I appreciate very much the testimony of Mr. Bill Carpine, Secretary/Treasurer of the Seattle Metal Trades Council, and Mr. Hans Schaefer, president of Todd Pacific Shipyard. I understand Mr. Carpine had to rearrange his schedule to fly in from Seattle, Washington to testify before us today.

Finally, I would like to commend Congressman Bennett, Chairman of the House Armed Services Subcommittee on Seapower and Strategic and Critical Materials, for his expertise and commitment to this issue and for his persistence in helping to create the Commission on Merchant Marine and Defense. The report from the Commission and its forthcoming recommendations will, hopefully, help focus national attention on this critical issue—national security implications of the health of our U.S. merchant marine and our shipbuilding capabilities.

Mr. ANDERSON. Thank you, Mr. Lowry.

Mr. Shumway?

[No response.]

Mr. ANDERSON. Mr. Dyson?

[No response.]

Mr. ANDERSON. Mr. Pickett?

[No response.]

Mr. ANDERSON. Mr. Coble?

Mr. COBLE. No statement, Mr. Chairman.

Mr. ANDERSON. Mr. Bateman?

[No response.]

Mr. ANDERSON. Mr. Miller, opening statement?

Mr. MILLER. Mr. Chairman, with your permission we will include the opening statement in the record.

Mr. ANDERSON. Mr. Miller requests that his opening statement be included in the record. No objection, so ordered.

[The prepared statement of Mr. Miller follows:]

STATEMENT OF HON. JOHN R. MILLER, A U.S. REPRESENTATIVE FROM WASHINGTON

Mr. Chairman, the fate of our shipbuilding industry is very important to me and to my constituents. The shipbuilding and ship repair industry in Puget Sound is a shadow of what it once was. The excellent memo the staff has prepared gives us a clear picture of the national scope of this problem. Today, we need to begin to talk about the solutions.

Each of us concerned about the fate of our shipyards can recite both the national and local statistics about the closing of shipyards and the loss of jobs. I want to thank you for holding this hearing not as a forum to push for another symbolic bill, but as a step toward educating us—the members of this committee. Our patient is in critical condition. To the people who work in the shipyards, to the ships which depend on them for repairs, and to our national security we cannot afford to lose this vital industry.

Mr. Chairman, I look forward to listening to the comments of our witnesses. I also look forward to working with everyone who is concerned about the fate of our shipyards to develop realistic and workable legislation.

Mr. ANDERSON. I also ask unanimous consent to place into the hearing record a statement from the Los Angeles-Long Beach Harbor Repair Council. No objection, so ordered.

[The prepared statement of the Los Angeles-Long Beach Harbor Repair Council may be found at the end of the hearing.]

Mr. ANDERSON. Our first witness today is Rear Admiral Roger B. Horne, Deputy Commander for Industrial and Facility Management, Naval Sea Systems Command, Department of the Navy. He will be accompanied by William A. Tarbell, the Deputy Commander for Acquisition, Planning, and Appraisal of the Naval Sea Systems Command.

We do have your prepared statement. Your prepared statement will appear in the record. You can read it, extemporize, present it any way you wish. Admiral, the floor is yours.

STATEMENT OF REAR ADM. ROGER B. HORNE, JR., DEPUTY COMMANDER FOR INDUSTRIAL AND FACILITY MANAGEMENT, NAVAL SEA SYSTEMS COMMAND, DEPARTMENT OF THE NAVY, ACCOMPANIED BY WILLIAM A. TARBELL, DEPUTY COMMANDER FOR ACQUISITION, PLANNING AND APPRAISAL, NAVAL SEA SYSTEMS COMMAND

Admiral HORNE. Mr. Chairman, I would like to read my statement. It is short.

From the Navy's vantage point, it is essential that we have a maritime industrial base capable of supporting our fleet and to provide the surge capacity necessary to meet mobilization demands. My remarks will address how changes in the Navy ship workload, ship design, and maintenance policy are expected to impact the maritime industrial base over the next 10 years. I will also address our policy for assigning and competing the work that is available.

The maintenance of the 600-ship Navy requires a sustained construction rate of about 20 ships per year. There will also be four to eight ships per year involved in conversion to other uses or induction into the reserve fleet. These figures are, of course, down from recent years since the goal of 600 ships is close to being attained. They also could change as a result of budget cuts. At any rate, planned naval ship construction will not support very many shipbuilders in the years to come, certainly not an increase in the number of shipbuilders.

A significant reduction in Navy ship work can also be expected in the area of ship overhaul and modernization over the next few years. This is happening for a couple of reasons. Changes in ship design, specifically the use of gas turbines instead of steam plants in many of our mid-size surface ships, has lengthened the period of time between the overhauls of these ships. Also, our nuclear ships can now go for a longer period of time between refueling overhauls. These design advances, coupled with general use of material and equipment with longer service life, has allowed us to change our maintenance strategies to increase the interval between overhauls and to add one or more short-term availabilities between overhauls. During the next four years, over 80 percent of the planned availabilities are scheduled for less than four months. Although we have not used these maintenance policies over a long period, it is believed that we will see cost savings. There is also the advantage of our fleet assets spending less time in depot maintenance.

As it turns out, planned overhaul cycles will result in a decrease of complex ship overhauls over the next few years. Then, because of several complex ships that will come in for overhaul, there is an upturn in work starting in about 1993 that will go on for several years.

Faced with increasing competition for declining available work, all shipyards have instituted aggressive programs to increase efficiency, reduce manpower, control overhead, and reduce costs. All of these factors, coupled with a very steep decline in civilian ship repair and shipbuilding work, clearly dictate a sharp reduction in shipyard work available and, therefore, employment nationwide.

As the maritime industrial base decreases, it carries with it irretrievable assets: skilled manpower and facilities. Given the complex nature of modern ships, skilled and trained tradesmen are a necessity. If our workload were to remain low and there were no need for a mobilization surge capability, there would be no need for concern. Market forces would take us to an appropriate level. However, the workload will not remain as low as it will go for the next few years, and it will be necessary to rebuild our skill base to accomplish the work expected in the mid-1990's.

Also, we must maintain an appropriate mobilization core. We must manage the work that is available very carefully to preserve our most critical skills.

Attempting to level the workload is a very dynamic process involving fleet schedules, maintenance requirements, budget constraints, and the geographic location of resources and ships to be maintained. It is always subject to change. We have been somewhat successful in changing some maintenance schedules to alleviate the problems between now and 1992, and we are continuing the effort.

The general Navy policies that are being used in this process are: maintenance of an industrial base colocated with fleet units; maintenance of a secondary industrial base in areas distant from fleet locations; construction of quality and capable ships at the least cost to the taxpayer; and maintenance of an adequate competition for Navy work.

The Navy policies, however, must take into account the welfare and quality of life of its personnel. As has been adequately demonstrated in the past, a perceived short-term savings which does not consider such factors as family separation and operating tempo can easily precipitate a significant long-term liability in personnel management areas.

Based on the above, for ships competed in the private sector or competed between the public and private sector, Navy construction, overhaul, and repair policy is as follows:

(1) All new construction work is accomplished in the private sector and bid nationwide. It's approximately $11 billion per year now.

(2) All deployable ship availabilities of greater than six months' duration are bid coastwide; approximately $930 million per year.

(3) All deployable ship maintenance periods of less than six months' duration are bid in the homeport area only; about $850 million per year.

(4) All shipyard work on MSC ships and reserve force ships is bid coastwide. MARAD shipyard work on the NDRF is solicited nationwide as a matter of DOT policy. For the combined work, that's about $1 billion per year.

In regard to the public sector, it is the Navy's policy to retain a strategic industrial base capable of doing certain types of work in different geographical locations. Our current policy is to maintain two shipyards on each coast capable of repairing aircraft carriers, to maintain one shipyard on each coast capable of repairing surface nuclear ships, to maintain three shipyards on each coast capable of overhauling nuclear submarines, to maintain three shipyards on each coast capable of installing, checking out and repairing current state of the art electronics and missile weapon systems, and to maintain Pearl Harbor Naval Shipyard capable of emergency repairs of all Pacific ships and capable of overhauling all ship types homeported in Hawaii.

There is very little flexibility in naval shipyard workload planning because of the type of work which must be accomplished. For all intents and purposes, Portsmouth and Mare Island are committed to submarine work. More than 80 percent of the planned workload at Puget Sound is comprised of nuclear surface ships and submarines. Over 70 percent of the Norfolk workload supports nuclear surface ships, submarines, and carriers. At Charleston, submarines make up about 60 percent of the workload with another 16 percent allocated to surface combatants. Pearl Harbor has a workload similar to Charleston's with submarines and surface combatants making up about 70 percent of the total. CV SLEP overhauls are more than 60 percent of Philadelphia's workload, and Long Beach is heavily committed to conventional surface combatants and other complex surface ships.

A fair amount of the remaining work accomplished by the Navy yards is unplanned work that must be done quickly and often in remote sites to support the fleet. During fiscal year 1986 and the first half of fiscal year 1987, over 252,000 mandays of off-yard work was necessary. Relatively little work remains in the Navy yards that can be accomplished in facilities outside the Navy yards.

In summary, Mr. Chairman, the Navy recognizes the importance of a strong maritime industrial base not only for the surge requirements, but to support an existing modern Navy of complex ships. We see that base shrinking further over the next few years due to a combination of factors. However, we also see an upswing in work in the mid-1990's. We are attempting to manage the work that is available in the near future to assure we retain our most critical skills and facilities while at the same time fostering an environment that provides capable ships at the least cost. It is most important that we succeed as the skill level required to build and maintain today's ships cannot be developed quickly.

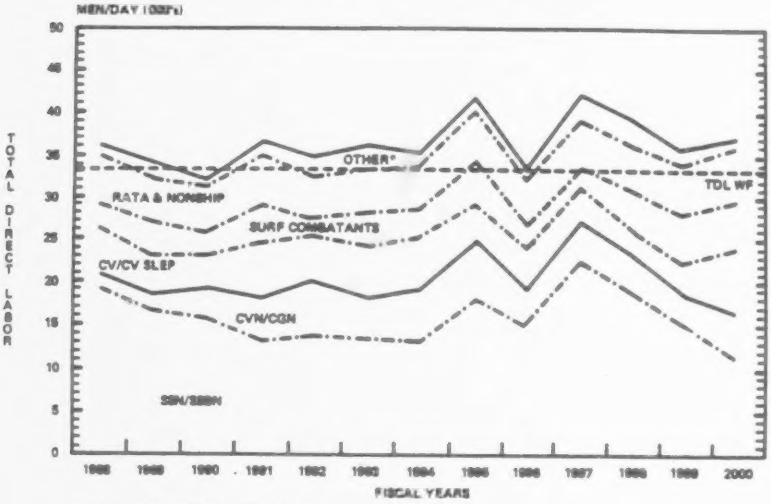
Mr. Chairman, I would be very happy to answer any questions.

[The enclosures to Admiral Horne's testimony follow:]

(Attachments to statement of Rear Admiral Roger B. Horne, USN, Deputy Commander for Industrial and Facility Management, Naval Sea Systems Command, before the Subcommittee on Merchant Marine, 8 December 1987)

NAVAL SHIPYARD PEACETIME WORK

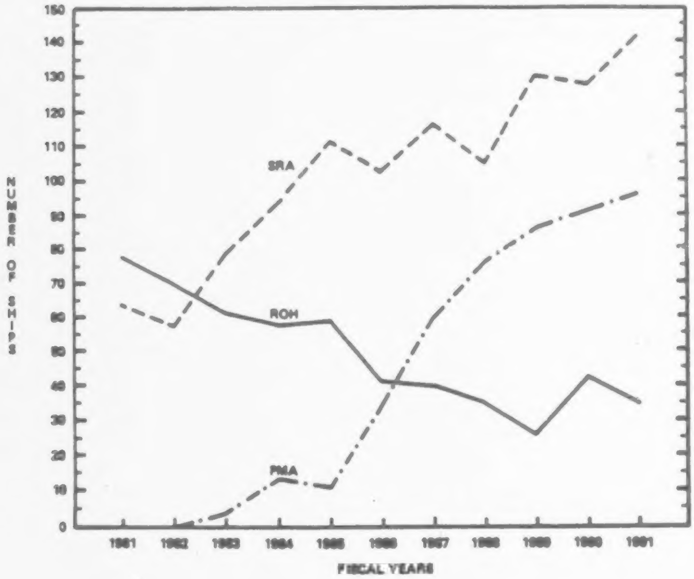
WORKLOAD BY CLASS (FISCAL YEARS 1988-2000)



*INCLUDES: AS/ASR/AGF/ATS/LHA/LCC/LHD

SHIPYARD AVAILABILITIES

(FISCAL YEARS 1981-1991)



(Source: Navy, 8 December 1987)

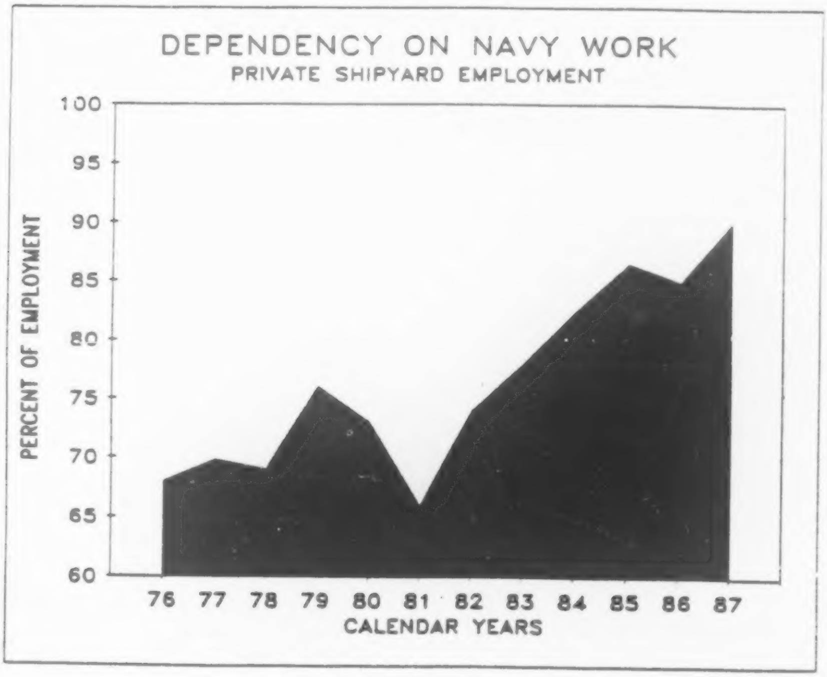
SHIPYARD INDUSTRIAL BASE

- LOSS OF PRIVATE SHIPYARDS

	ALL (400' Cap.)	Large
1982	110	11
1987	81	9

- DECLINE IN AVAILABLE SHIPBUILDING POSITIONS FROM 253 TO 218

- 9 SHIPYARDS IN CHAPTER 11:
  - -- 6 (400' CAPABLE)
  - -- 3 LARGE



Mr. ANDERSON. Admiral, the number of production workers in West Coast yards has declined 51 percent since 1982 compared to 14 percent nationally and one percent on the East Coast. Now, you state that irretrievable assets—namely, existing facilities and skilled workers—are being lost. Where do you expect to find production workers on the West Coast in the event of a war or a national emergency?

Admiral HORNE. It would be very difficult, Mr. Chairman, as the base goes down. There are two parts to the base. One is the total number of people who are familiar with maritime work. And there is also the number of the very highly skilled people that we need. As the work decreases, I think we will have some difficulty in locating those people.

Mr. ANDERSON. Does the Navy mobilization policy call for constructing ships on all three coasts? And can you explain why the Navy seems to be moving away from construction on the West Coast?

Admiral HORNE. I don't believe that there is a policy in ship construction to construct on all three coasts—that is, a written policy that I'm aware of, sir.

It is being determined now by the shipyards that have the facilities existing that are able to win the contracts. On the West Coast, labor rates are in general significantly higher than we see on the East Coast. And I think probably that more than anything else has worked against the West Coast shipyards.

Mr. ANDERSON. How would a lack of West Coast ship construction and repair capability affect a shipyard mobilization effort?

Admiral HORNE. From the shipbuilding and strategic standpoint, of course, it would be desirable to have our yards spread out geographically. However, in the shipbuilding area, it is probably not as important as in ship overhaul and repair. We need to be able to repair battle damage on both coasts and to mobilize quickly on both coasts in order to support the fleets that are located there. So, it is certainly important to us to maintain a ship overhaul and repair capability on both coasts.

Mr. ANDERSON. How would a lack of West Coast ship construction and repair capability affect our Nation's ability to meet commercial needs in the event of a war or a national emergency?

Admiral HORNE. I think the ability to have a capability on both coasts to expand from the merchant fleet is similar to the needs for the Navy capability. I would think it would be mostly in the ability to get the merchant ships out to sea and to get the requisite repairs made and so forth. Ship construction, I think, is probably not as critical as ship overhaul.

Mr. ANDERSON. Does the Navy's rotation of personnel assigned to shipyards have a negative impact on efficiency?

Admiral HORNE. You are speaking about Navy people who run the shipyards, sir?

Mr. ANDERSON. Yes, I would think so.

Admiral HORNE. I don't think so. We have a career pattern for our public shipyard managers. They spend many years in the shipyard business before they achieve command. I would say that on the average our Navy managers have at least 10 years of experience in the shipyards. And we hold them in those positions—a shipyard command will normally remain in command at least three years, and in a lot of cases four years; sometimes five years. So, we rotate a little differently than the operating forces do in those technical positions.

Mr. ANDERSON. Mr. Biaggi?

Mr. BIAGGI. Thank you, Admiral, for your statement.

There is one message that comes through loud and clear. I can see a repetition of the condition that we found ourselves in prior to World War II. We didn't have sealift capability, and it delayed the delivery of provisions to our troops, which had a very disastrous impact on them.

It just boggles my mind to think that we are heading down almost a suicide path in the way of national defense with relation to the sea. And really not much is being done about it. If we don't have the capability to produce, notwithstanding the 600-ship fleet, this Nation is in serious trouble.

Of course, you are not responsible for that, but it's a realistic assessment of what we are looking at. And what we do here—well, we do the best we can with what we have, but we need a change of policy. I'm not just talking about this Administration, but most of them. I referred to former President Nixon before. He's the only one that really helped. I think he built 60 or 70 ships during one program, and then that stopped. But somehow the whole shipping industry has been neglected.

There are a number of concerns. I think my colleague, Mr. Lowry, raised one in relation to the bidding process. Would you comment on GAO's conclusion that industry is currently competing in a low-ball or close to a marginal profit environment on Navy ship construction?

The minute you start talking about low margin, low ball, there has to be an impact on quality. Now, what is the attitude to begin with? Is there a mandate to come in with vessels that meet a given price, that meet the estimate? And if so, is that estimate determined by factoring in elements of the construction of lesser quality ships? This happens not simply with the Navy. It happens in all construction. We have seen it happen time and time again.

But I understand that as an agency in the service of the Government you have mandates. You must struggle to live within those mandates. I think we should lay it out there so we can all see. Are we putting out the first-rate ship, the ship that we used to put out, the quality of ship that we used to put out when quality was important, or are we required to compromise?

Admiral HORNE. There are a couple of ways in which a shipyard company can go under. One way is not to get any work. Another way is not to be able to recover their costs or to get sufficient profit as a result of their bids.

When you are in a situation where you have declining work available for the yards and several ship overhaul and shipbuilders competing for that work, the dynamics are such that the bid prices generally go down. And we do see, as a result, low bid prices in below the Government estimate. I would like to say that the Government estimate includes some contingency for growth which, of course, is not generally in the bid that the company might be making. So, you would expect to see some difference. But we do see quite a bit of difference between the award price and the Government estimate in the final cost and that may go higher, between 30 and 50 percent.

I can't say that we know of any cases where they are not able to recover their costs. We do have some companies going out of business. But they put in for new work. And then, of course, they put in claims if they need to recover their costs that way.

We have located next to each of the private shipyards a Supervisor of Shipbuilding, Conversion and Repair office whose responsibility it is to see that the contract is carried out in accordance with the requirements, the specifications. In general, I think, we do not see cases where the quality of the ship is materially affected, perhaps as a result of the supervisor's presence. And, of course, the shipbuilders are reputable, in general. I don't think they want to turn out a bad product. But we do have early, significant safeguards against the product quality degrading.

But we do have a problem in this situation that we are in with the competition being the way that it is and the difficulty that the private shipbuilders and even the public shipyards that are now in competition have to face.

That is a long answer. But from the quality standpoint, sir, I don't see that as much as a problem as I do some of the other parts of it.

Mr. Biaggi. If I understand you correctly, what you are saying is, because of the lack of work, the shipyards are competing to their own detriment in order to get some work to keep alive for a little bit. That is just prolonged agony, isn't it?

But in any event, aside from that, should a two-tiered Navy evaluation process that would take a company's track record into consideration be implemented?

Admiral Horne. I'm sorry, sir. I couldn't hear. The mike is cutting out.

Mr. Biaggi. My fault. Should a two-tiered Navy evaluation process that would take a company's track record into consideration be implemented?

Admiral Horne. I am not in that part of the evaluation of contracts, and my particular background doesn't allow me to answer that. However, we do at times use a bid process where we do evaluate not only on the basis of price but on the basis of a technical capability to proceed. However, most of our contracts, I think, are being let solely on price. We should not obviously give contracts to people who are technically unable to perform.

Mr. Biaggi. On another point, Admiral, recently in a Department of Defense authorization bill, the Secretary was given authority to enter into long-term charters. What impact will that have on shipyards? And how long does the Secretary have to wait, or what is the intervening period?

Admiral Horne. Sir, I would have to take that question for the record. I am not in a position where I am familiar with the long-term charters. I haven't really looked at that to be able to give you a good answer.

[The information follows:]

EFFECT OF LONG-TERM CHARTERS

The impact of long-term charters is affected by many other issues and pending legislation which have hampered analysis efforts and prohibited reaching clear conclusions. The issues of construction-differential subsidies, operating-differential subsidies, procure-and-charter programs, changes in currency exchange rates, and the specific ship types, sizes, quantities, and duration of the long-term charter program are some examples of the questions which must be resolved before clear conclusions can be reached. Long-term charters could serve to slow the decline in the U.S. shipbuilding industry through promotion of new ship construction if corresponding legislation or regulation mandated use of U.S. shipyards. However, long-term charters alone will be insufficient to support the U.S. shipbuilding industry.

Mr. BIAGGI. Thank you. We'd appreciate that.

One last question, Mr. Chairman. How many shipyards does the U.S. need for its mobilization base?

Admiral HORNE. How many shipyards does the United States Navy need for its mobilization base?

Mr. BIAGGI. Right.

Admiral HORNE. I think we need to have the eight public yards that we have now. In the private sector we would need to have a number that would get us up to the surge that we would need to have immediately—and I don't have a number to give you on that—and then a number to sustain it. I suspect that we have at this time a base that is probably capable of doing that. But if it continues to decrease, there would be a serious problem.

Mr. BIAGGI. You say in the present situation we have a surge capability?

Admiral HORNE. I would say I am speaking now of the ability of the Navy to support its combatant ships and not speaking to the maritime part. I believe that we could support with Navy combatant ships the base that we have now. I am not expert to answer the maritime question.

I am concerned not so much about the total numbers of yards needed to maintain the combatants, but the potential loss of the requisite skill levels within the yards that we have to maintain if we lose those. We can have numbers of people and not be able to handle the technical work that our complex ships require today. We cannot let this base go much lower and have what we need.

Mr. BIAGGI. There is no question that is a critical concern. We have seen that whole skilled work force diminish over the years. Now, we may be reaching an even more critical stage. But what is interesting in your response is you believe we have a surge capability to deal with the Navy's requirements. I think you made some reference with relation to the maritime requirements.

Would it be fair to conclude that we wouldn't have a surge capability to deal with the total picture?

Admiral HORNE. The total picture? I am not familiar enough with total shipping requirements and the different scenarios, sir, to give you a real good answer on that.

I would be concerned that we are relying perhaps too much—and this is just my opinion—on our ability to take advantage of the foreign ships. But there are agreements which are made, and if those agreements are fulfilled, I guess we are okay. But I am not an expert in that area, sir.

Mr. Biaggi. Well, I share your concern about our ability to get the foreign ships. That has always been a matter of contention. Thank you very much, Admiral.

Admiral Horne. Yes, sir.

Mr. Anderson. Mr. Saxton?

Mr. Saxton. Thank you, Mr. Chairman. And thank you, Admiral, for being here today. We have looked forward to the opportunity to talk with you about your position and your job, which I know given the circumstances is a very difficult one.

Let me ask you a question about your job. I understand that you oversee all of the ship construction process as well as systems aboard ships so that you are not only concerned with ship construction and repair itself, but also on-board systems?

Admiral Horne. I have the naval shipyards and the Supervisor of Shipbuilding, Conversion and Repair offices which monitor and administer the contracts for the private construction work and overhaul also. I am concerned that we are capable of doing that and that we do it properly.

I do not answer the technical issues that come up on the ship's systems on a day-to-day basis. That is handled by another director within NAVSEA. I, of course, have to execute those technical requirements.

Mr. Saxton. You are in a position to know as to the quality and competency of the systems that are on board in terms of today's record of reliability?

Admiral Horne. Yes, sir. I monitor that. I am very interested in the quality of the work that we do and how well the ships hold up overhaul. Yes, sir.

Mr. Saxton. Not long ago, because of a great deal of public concern and concern within the House, Congress instituted policies for the Navy and the Air Force and the Army to follow that have to do with dual-sourcing and with competitive bidding. Have you noticed any difference in the quality of components and of the ships themselves since that policy has been instituted or since we have been moving toward the institution of those policies?

Admiral Horne. We have had several problems as a result of competition. I don't think that we have any evidence of products where we have not caught the problems and corrected them prior to their getting into the fleet.

There are some advantages, obviously, to competition in bringing price down. It creates some problems with regard to knowing whether additional suppliers can meet the requirements. At times we find that we get people who cannot meet the requirements. When that happens, we have to take action.

I think we do see some of that, yes, sir. But I think we have an adequate way of catching it now. How effective it is from the standpoint of cost, that's something else.

Mr. Saxton. Some of the component parts of ships today would seem to me to be fairly technical——

Admiral Horne. Yes, sir.

Mr. Saxton [continuing]. That a great deal of expertise needs to be developed by the manufacturer of those technical elements. Have you seen any problem with regard to those elements specifically, particularly in terms of defense systems on board ships?

Admiral HORNE. Again, we have several cases where we find material that we did not get from the original equipment manufacturers where the quality has not been up to par perhaps for several reasons. One is that they may not have all of the technical data they need to have to manufacture the part, or they just don't have the same understanding of the manufacturing process as the original equipment manufacturer. We have caught several of those problems and have corrected them.

We trade that off, I guess, against the advantage of having competition. And that is a judgment call.

Mr. SAXTON. I guess one could draw the conclusion from what you are saying that there are certain technical operations that can safely be dual-sourced, and there are some that perhaps ought not to be.

Admiral HORNE. Yes, sir. There are some things that lend themselves to dual-sourcing. However, in some cases, the products, specifications, and the original equipment manufacturer's capability are so difficult to define that by competing or dual-sourcing them, losses occur. So, there is a point there where you ought to go back to the original equipment manufacturer.

Mr. SAXTON. Okay, thank you.

Let me just turn to one other subject. In your testimony you made it fairly clear that—well, two things—one, that there has been a decline in our shipbuilding capacity and our ship repair capacity because of I suppose lack of demand for repair and shipbuilding activities; and on the other hand, that the Navy's needs are somewhat cyclical, at least temporarily cyclical because we are at a rather low point now and will be increasing our demand in 1993 when you have certain repairs apparently programmed. Is that correct?

Admiral HORNE. Yes, sir. That's correct.

Mr. SAXTON. Has the Navy any plans to deal with that cyclical problem in terms of keeping private shipyards ready, or naval shipyards ready, or both? What are your plans exactly?

Admiral HORNE. We have conducted several studies. We have, I think, identified the problem that we are facing between now and about 1995. The problem exists mostly in the lower number of complex ship overhauls which are going to take place during that time. Because of the extended overhaul cycles and the age of these particular ships, we are now going through a period where we do not have as much work as I would like to have. But it turns out that these ships are going to need overhauls starting at about 1993 or a little bit earlier. Then we have an overload situation where we are going to need all the facilities that we have available to us, and we are going to need those special high technical skills required to maintain complex ships.

Now, we have identified the problem. We are working with the operating fleet to see what schedule changes can be accomplished in order to try to bring some of that work forward or to slip it further off to a little bit later in order to alleviate that situation. This and the current budget cuts makes this a very complex process. The only solution that I see is to reschedule some of these ships. That's about the only thing I can see we can do.

Mr. SAXTON. Thank you very much, Admiral.

Thank you, Mr. Chairman.

Mr. ANDERSON. Mr. Lowry?

Mr. LOWRY. Thank you, Mr. Chairman, and thank you, Admiral, for being here to answer some very tough questions just because of the situation in which we find ourselves.

Just as a side line, I would like to say that, continually, the most important national security issue is a need for a tax increase. And I just continue to wonder how anybody thinks we can do these things with appropriated funds. Everybody keeps thinking we can do them and not have any revenue to do them with.

Now, to follow up on Mr. Biaggi's question on the importance of maintaining a skilled labor force, I do have what to me is a tough question and something that really bothered me when I found out about it which I had both been communicated with about and then I also read about in the paper. According to this newspaper article, the Navy brought in 109 Japanese and Filipino workers to work in the Long Beach and Philadelphia shipyards while at this same time we are having this horrendous number of unemployed skilled workers in so many communities around the country. And of course, I am extremely aware of that in Seattle where it is just a disaster.

And the last part of the article says, "Some lawmakers protested loudly and furiously." That's true. At least that part of the article is accurate. That I know.

How did this happen? Under what authority did the Navy import the workers? I really don't quite understand legally how that happened. And so, that's the first question, Admiral. And then, secondly, is this going to happen again?

Admiral HORNE. To answer your last question first, no, sir.

But I would like to give you the background on it. It lends itself very much, I think, to the questions that you are asking in these other areas.

We needed to have workers in two shipyards, Philadelphia and Long Beach. We needed to have skills in Philadelphia in the electrical and electronic area. Philadelphia has been trying to hire those skills for over six months. They are spending or were spending on the average of $3,000 a week advertising for those skills. Long Beach needed ship fitters and welders.

The need for skilled labor was discussed with the unions. Their ship schedules were slipping. In the shipbuilding or ship overhaul business, if you are missing critical skills, the construction or overhaul cycle can get out of the sequence so that other workers have to stand by and wait and can't be used effectively.

We tried to go to the other Navy yards to borrow and transfer skilled workers, but we had a shortage of these skills throughout.

One solution was to use people from the ship repair facilities overseas. Now, these are employees that work for U.S. Government overseas. They are not people that are just off of the market overseas. They have all of the requisite legal requirements and are authorized to work in the United States. So, we made a cost analysis to see if it was going to cost us money to do that. It turns out that, even though we pay these people per diem, the overall cost to the Government would have been less. And, certainly, it solved the inefficiency of being out of sequence with the rest of the ship's work.

So, a decision was made that it was in the best interest of the Government to do that.

In hindsight, it was probably an insensitive signal to workers in the United States, and I think we probably underestimated that factor.

But we have sent those people back and have still not been able to hire skilled workers. We are slipping the schedules in those yards as a result of having to send them back. And it is costing us money.

Mr. ANDERSON. Will the gentleman yield?

Mr. LOWRY. I yield to the Chairman.

Mr. ANDERSON. One of those shipyards happens to be in my district.

It is my understanding—I could be wrong—we have basically two United States Navy yards in that area. One of which is in Japan.

Admiral HORNE. We have one in Subic Bay in the Philippines.

Mr. ANDERSON [continuing]. The other is in the Philippines. These were the people they were bringing over. They are under contract working for the United States Government but they are not American citizens.

Admiral HORNE. No, sir.

Mr. ANDERSON. So, what they were bringing was non-American citizens into an area to work obviously at a lower rate. My understanding was that one of the reasons you couldn't get boilermakers was because what you pay is less than what boilermakers get paid in the private sector in Los Angeles and so on.

Admiral HORNE. Yes, sir.

Mr. ANDERSON. We are importing non-American citizens from foreign places that are working for us because they are willing to work for lower wages than their American counterparts, but they are Japanese citizens and Philippine citizens. So, we have here a very difficult problem.

Admiral HORNE. A very difficult one. And yes, sir, we have a lot of difficulty hiring right now.

Mr. LOWRY. It's a difficult problem in which your first answer was an excellent answer, Admiral. The problem does have an answer, and you gave it. And I appreciate that.

Well, Mr. Chairman, I probably used up my 5 minutes. I will wait for my next round to ask further questions.

Mr. ANDERSON. Well, continue.

Mr. LOWRY. Yes. Do you know approximately, Admiral, the difference in pay between the workers that were brought in from Japan and the Philippines?

Admiral HORNE. No, sir. I'd have to take that for the record. I do know, and I double-checked to make sure that we didn't do something dumb from an overall cost standpoint, that we didn't pay more money as a result of the per diem and travel costs. That was not the case. We paid less, but I don't know the exact amount. It is significant.

[The information follows:]

PAY FOR JAPANESE AND FILIPINO WORKERS

The Philadelphia Naval Shipyard paid the Japanese $11.00 per hour and the workers from Subic Bay were paid $3.35 an hour. Long Beach Naval Shipyard paid the Government of Japan $12.01 per hour for each of the workers. No bonuses or incentives were paid.

Mr. LOWRY. Thank you.

Mr. BIAGGI. Will the gentleman yield for just a moment?

Mr. LOWRY. Yes.

Mr. BIAGGI. Tell me if I understood this correctly. You are saying that you couldn't get help. But the Chairman, Mr. Anderson, stated that there is a disparity in wages. Let me put this question to you. If you paid them more, could you get the help, the employees?

Admiral HORNE. I think one of the problems that we face now in our industry, the ship overhaul, the shipbuilding industry, is that fewer and fewer people are interested in doing our kind of work.

Mr. BIAGGI. Yes, except you are not responding to my question, not precisely, Admiral. I asked you a question. If you paid the equivalent to what they are getting in outside industry, would there be people available for employment?

Admiral HORNE. I think so, yes, sir.

Mr. BIAGGI. That's the question.

Mr. LOWRY. Taking back the time, and thank you. I know, Mr. Chairman, you are going to have to move in.

Obviously, we believe because we know our trades, that we have a tremendous number of well-skilled people who do want to work.

Thank you very much, Admiral.

Mr. ANDERSON. Mr. Miller?

Mr. MILLER. Thank you, Mr. Chairman.

Admiral, I think the members of this committee that are listening to you today, most if not all of us come from areas where we have seen and felt this shipyard decline. That may make us a little more sensitive.

I would like to get to a different area, but it does relate to wage rates.

When you are looking at apportioning out the work—East Coast, Gulf Coast, West Coast—there are differences in wage rates, as I understand it. As I understand it, the wage levels on the West Coast are somewhat higher. Is that correct?

Admiral HORNE. Yes, sir.

Mr. MILLER. When you are looking at that, in addition to taking into account the hourly wage rates, do you in making your computations take into account the value of the work? Do you measure the skill and expertise of the workers? Is that at all factored into your decisions?

Admiral HORNE. In making a contract award?

Mr. MILLER. Yes.

Admiral HORNE. Again, I don't get involved in making the awards, sir, so I don't do this evaluation. But my understanding of the process is that if it is strictly on a price-type, single-tier type contract, you do it on low price with the understanding, after review, that the contractor has the facilities and has done similar work in the past and has the financial wherewithal to sustain a loss if the bid is low.

When you go to a two-part bid, you weigh the relative technical merits of the individual competitors. On a single-type process, you don't weigh the relative technical capabilities of the different competitors. You just assess whether or not they have the capability to do it. And we are doing mostly that type of contracting right now.

Mr. MILLER. I just want to make sure I understand. So, in the contracts that are going out under you, it is what you refer to as the single-type process where you are not weighing the technical capabilities or the quality of the work. You are looking at the wage comparison and whether the firm is financially solvent and has done work in the past.

Admiral HORNE. Done similar work in the past and has a reasonable capability of doing it properly as opposed to weighing the relative capability. One might have a stronger engineering capability than another.

Mr. MILLER. Yes.

Admiral HORNE. And, if you were doing a two-step process, you would be giving a weighted factor to those relative capabilities as opposed to just saying, yes, he does have the capability, or it is reasonable that he can perform it.

Mr. MILLER. Would you be in favor of going to this two-step kind of weighing process that you have described?

Admiral HORNE. Again, this is out of my realm. But when we deal with complex contracts for very complex systems and ships, there are some advantages to that process. This is out of my——

Mr. MILLER. So, you see some advantages to doing it that way. What would it take to make the change to do it that way?

Admiral HORNE. Again, I would have to take this for the record. In some cases, it is done that way. I am not sure just exactly which contracts were awarded that way and which ones were not, sir. But for those cases where we are dealing with a very complex product, I think we should do it that way.

And that's a policy, to answer your question directly, of the Assistant Secretary of the Navy for Shipbuilding and Logistics and our contracting personnel when they go out for bids. They make that decision.

Mr. MILLER. So, they make the decision whether to go to the single-step process or the two-step process?

Admiral HORNE. Mr. Tarbell might be able to answer that better than I.

Mr. TARBELL. Yes, sir. The provisions are in the contract law to do as you suggest. In fact, we generally do consider the technical capabilities of the companies in the area of new construction as opposed to perhaps the area of repairs. We do generally look at the technical capabilities and the reasonableness of the cost estimate and consider the capability of the company to take on the task in the contract and his financial health and so forth.

So, I believe, in direct answer to your questions, the provisions are already in the regulations to allow and we, in fact, do implement——

Mr. MILLER. You are saying you have discretion, and you exercise that discretion, and you do use this two-phase process.

Mr. TARBELL. Generally, in the ship acquisition programs.

Mr. MILLER. Generally. And just to be clear on this, when you look at technical capability of a company, does that mean you are looking at the quality of the work that the workers for that company have put out?

Mr. **TARBELL**. Yes, sir.

Mr. **MILLER**. I think I have probably used up my time. I'll yield for now.

Mr. **ANDERSON**. Mr. Foglietta?

Mr. **FOGLIETTA**. Thank you, Mr. Chairman.

I would like to follow up basically on the questions that were being asked by Mr. Lowry and Mr. Biaggi. Isn't it true that the skilled employees that we need so desperately in our shipyards, which were replaced by the foreign employees, are not available to us for no other reason except that there is not a steady flow of work at union scale into these yards? I know that is the problem in the Philadelphia Naval Shipyard that I represent. The skilled employees would be very willing to be employed at the naval shipyard, but they don't want to work three months a year or they don't want to sit back and hope that a ship is going to come in in the next three months that they can work on or else be laid off.

Now, I understand that you did make a statement before I arrived that you believed that the existing naval shipyards should remain open. And I hope that you include Philadelphia in that.

But wouldn't a more regular and contemporary, up-to-date flow of ships and an assured flow of shipyard work be the answer to obtaining and retaining skilled workers?

Admiral **HORNE**. Yes, sir. If you can optimize a workload for a shipyard, show good solid employment into the future, and have reasonable wages, you can retain people.

In general, young people are becoming less and less interested in working in our industry partially because of its decline, and partially because it's hard work. Wages are not as rewarding as they can probably get somewhere else. But also there is the fact that there is no stability. So, that presents us with a problem.

Mr. **FOGLIETTA**. Well, we have an apprentice program at the Philadelphia Naval Shipyard which is a thriving program. It is working very well. We have no lack of young people wanting to learn these trades and to become involved as employees there. Is there any way that you might suggest that we can get a better flow of work and also a more secure projection into the future as to what is coming?

As it exists now, we have a meeting every two or three months at the Navy shipyard. We say where is the work coming from for the next three months? This is aside from the SLEP program. The SLEP program is pretty secure into the future for a few years, we hope. I am talking about the other work. Is there any way that you could suggest that be done?

Admiral **HORNE**. Well, we work very, very hard at this problem. With the swings in the workload that we have, it is extremely difficult. It is difficult for a couple of reasons. As I said, the overall work is going down. But the nature of our business is that a lot of these overhauls involve over 1,000 men a day working on a ship. And when that ship finishes, then you have these big swings in employment. You cannot schedule work solely to satisfy the employment. You also have the operating problems. You have deployment schedules. The yards have to react to the needs of the fleet. So, unless you have an abundance of work, an overload in general in the industry by some 10 percent or so, it is very difficult to maintain the kind of thing you are asking for.

I don't have a good suggestion other than the fact that we need to very carefully manage the work that we have available to lessen the impact. We are trying very hard to do that. And it's a real problem, and it is going to get worse for the next few years as I see it.

Mr. FOGLIETTA. Well, thank you, Admiral.

Mr. Chairman, may I ask unanimous consent to enter a statement in the record that I was supposed to enter at the beginning of this meeting?

Mr. ANDERSON. No objection, so ordered.

Mr. FOGLIETTA. Thank you.

[The prepared statement of Mr. Foglietta follows:]

STATEMENT OF HON. THOMAS M. FOGLIETTA, A U.S. REPRESENTATIVE FROM PENNSYLVANIA

Mr. Chairman, I want to thank you for holding this hearing on this issue of such vital importance to this Nation's security, the state of the U.S. shipbuilding and ship repair industries. Though I hope I am wrong, I doubt that much of what we will hear today will be new. All of the Members of the Subcommittee on the Merchant Marine are well aware of the dire situation facing these industries. We have held many hearings on this topic, and supported many initiatives, but still the problem remains.

There is one significant difference between this hearing and those we have had before. Today, we meet to discuss the issue with the support of the Report of the President's Commission on the Merchant Marine and Defense. The Commission's report stated, and I quote, "Major government effort is required to reverse the decline in our maritime industries."

This is what the Members of the Merchant Marine Subcommittee have been telling the President for years. Maybe this report will get his attention.

Let me just outline a few more of the conclusions of the Commission's report.

Maritime industries are and will be for the foreseeable future an essential military asset to meet strategic sealift requirements.

Government should provide a business environment where maritime industries are not impeded in competing on a fair basis, both at home and abroad.

The rapidly deteriorating situation should be addressed by an affirmation and restatement of our national maritime policy, to include: commitment to developing the necessary maritime resources to meet national defense requirements; maintenance of a balance between an active commercial fleet and inactive reserve sealift forces, with emphasis on the former; and recognition that any new Government expenditures in support of the maritime industries should be justified by national defense requirements and the costs borne by the nation as a whole.

The question before us today, then, is not if the shipbuilding and ship repair industries require and merit Government support. The question is how we are going to support this vital industry, what initiatives should be taken, what programs introduced, and most importantly, how are we going to get a President who for seven years has been deaf to all our pleas to get involved. Many of the witnesses who will testify today have submitted interesting and worthy proposals. It is my hope that today we can begin to put some of these proposals into action, and restore this industry to its rightful place.

Mr. ANDERSON. Mr. Bateman?

Mr. BATEMAN. Thank you, Mr. Chairman.

This, of course, is almost *de minimis* of the total problem, Admiral, but I am from the Government and I want to try and help you. And I don't fully understand the inability to obtain American shipbuilding skills without recourse to bringing foreign nationals from overseas to American shipyards. Therefore, I want to inquire as to specifically how your shipyard managers went about trying to meet their personnel manpower requirements.

For instance, did they make inquiries of the State employment agencies in those communities which have undergone significant reductions in shipbuilding jobs in the last year or two years?

Admiral HORNE. I don't know the answer to that specific question. I do know that they had been advertising for literally months in all the local and surrounding community newspapers to the tune of about $3,000 a week trying to get these skills. But I don't know for sure that they did it.

Mr. BATEMAN. But before bringing someone from Japan or from wherever else, wouldn't it seem logical in an industry that has suffered losses of thousands of shipbuilding and ship repair jobs to have sought from official agencies such as, for instance, the Virginia Employment Commission?

In my community we lost 1,200 or more shipbuilding jobs in December of 1986. All of those workers have not even returned to work. It seems to me that the Naval Sea Systems Command is more than cognizant of where its contractors in the private sector have lost significant numbers of shipbuilding jobs. We have, through support of the Federal Government and the taxpayers, employment commissions in every State in the Union whose function it is to try and place displaced, laid-off workers. It would seem to me that the obvious thing for your shipyard managers to do——

Admiral HORNE. Yes, sir.

Mr. BATEMAN [continuing]. Is to exhaust those resources and put American shipbuilders back to work.

Admiral HORNE. Yes, sir.

Mr. BATEMAN. I would hope that there would be a directive that in the future they would go to that very elemental step if they haven't in the past.

Admiral HORNE. Yes, sir. We do not intend to go in that direction again. And we still have not been able to hire these people. I will go back and check to see that we have used those methods as well as the others that we have used.

[The information follows:]

PLAN FOR HIRING SHIPYARD WORKERS

The Philadelphia Naval Shipyard had frequent contact, to no avail, with State unemployment representatives in Pennsylvania, New Jersey, and Delaware. The shipyard has a full time Pennsylvania State Unemployment Representative on board in the shipyard's Personnel Department. The shipyard also contacted large industrial cities experiencing layoffs (Johnstown, PA and Trenton, NJ) to inform them of the shipyard's employment opportunities. Through State unemployment contacts in Pennsylvania, employment opportunities were also offered to plants closing or laying off in Wisconsin and Virginia.

Long Beach Naval Shipyard also contacted State unemployment agencies and requested assistance from the Metal Trades Council.

These options were unsuccessful due to the short duration of our employment offer (2–3 months), low salary in comparison to union scale, and lack of health insurance benefits associated with temporary employment status.

Mr. BATEMAN. Well, if you haven't had recourse to that, I would suggest that, while undoubtedly there are difficulties of lack of continuity of job opportunity that may negatively impact and relocations costs, certainly I don't think that it bespeaks a concerted, exhaustive effort to put American shipbuilders to work if you haven't done what would seem to me to be one of the elementary things that should have been done. I hope I have made the point, and I won't beat this horse any further.

Admiral HORNE. Yes, sir.

Mr. BATEMAN. Thank you.

Mr. ANDERSON. Mr. Dyson?

Mr. DYSON. Thank you, Mr. Chairman.

Admiral, I have two questions for you. One, I would like to continue on with what Mr. Bateman was saying. When you brought these people in, they were already trained, is that correct? Is it true that those workers who came from the Philippines were people who had been working at our facility at Subic Bay? Just out of curiosity, who did their jobs when they were here? Who did their jobs at Subic Bay?

Admiral HORNE. Who did their job over there while they were here?

Mr. DYSON. Over there, yes.

Admiral HORNE. They were in a situation where there was an under-load. These were excess people that were available.

Mr. DYSON. So, are they doubly excess now that they are back, or are they still here?

Admiral HORNE. The ship repair facilities that are overseas do not come under my cognizance. They come under the fleet's cognizance. And I am not certain as to how they are loaded.

My understanding is that we did this through the fleet because they manage those facilities. They knew that we were unable to make our schedules on specific ships. And when we explored—when we were having a lot of dialogue as to how we were going to finish, it came out in that dialogue that these skills were available, that we could use them.

Mr. DYSON. Had that ever been done before?

Admiral HORNE. It has been done before for training purposes to train people for the ship repair facilities.

Mr. DYSON. Just for training?

Admiral HORNE. Yes, sir. I have been unable to come up with any other precedents. I have heard that it was done before, but I don't believe that it really was.

Mr. DYSON. Okay, a separate question. I have been reading through some of the documents provided by our staff. And one of the things that comes to mind is that there is not one oceangoing merchant ship under construction in a U.S. shipyard today. Of the work that goes on in the private shipyards today, 90 percent of it is naval. I guess we can't fault you for not providing us with any work.

What would the Navy do in the event of a war? I ask this almost every year. I happen to be also a member of the Armed Services Committee, the Seapower Subcommittee. I am well aware of the dramatic decline in some of these shipyards. Unless something should change, it appears that this decline will become even more dramatic. What if we had to reactivate some of these shipyards? I'm sure we would have to reactivate some of them in wartime. What kind of plan does the Navy have to do that sort of thing? I don't even know if you can go this far, but which ones would you reactivate?

Admiral HORNE. Bill, do you have any knowledge of any plan to reactivate? I don't know of any plan.

Mr. TARBELL. I presume that you are talking about reactivating naval shipyards that have been closed or private shipyards?

Mr. DYSON. Well, both.

Mr. TARBELL. Either?

Mr. DYSON. Either.

Mr. TARBELL. There is no plan that I know of to reactivate. I think, as was mentioned earlier, at the present time we see an adequate industrial base to support the Navy's surge capabilities for naval ship construction.

Mr. DYSON. Well, that's under this kind of situation today.

Mr. TARBELL. Right now. That's correct. Yes, sir.

Mr. DYSON. Downtown they are now signing a document that says we're never going to go to war again I guess. But what if the scenario changes?

By looking through some of these papers here, I think our staff went back to 1947. I have seen what we were able to produce. And that total is considerably less today. And if things continue—let's say we could all be here in this room in another three, five years from now—it will be probably even less.

The Navy must have some policy, some proposal, to handle the situation if we were ever to get into a war. You would have to go back and open up some yards. You would have to try to find those skilled people again. You would have to reactivate those yards if we would ever hope to win a war.

Mr. TARBELL. Well, there would have to be an effort to do that, but I know of no such plan at the present time. In fact, the difficulty that we would see right now even before the shipbuilding capacity would be the lack of skilled labor, as the Admiral has mentioned, as well as the supplier base to support the standard shipbuilding program for a mobilization capability with the necessary components and combat systems. That is more of a critical path today——

Mr. DYSON. So, would we have to assume that what you would probably do in that situation is rely on foreign shipyards?

Mr. TARBELL. I can't answer that.

Admiral HORNE. I don't know that we can answer that, sir.

I do know that once a shipyard is shut down and its facilities are inactivated or used for other purposes that the condition of those facilities deteriorates very, very rapidly, and that to bring those facilities back on the line again is not going to be real easily done. It is not something you are going to do in a week or a month. When the cranes rust away, the tracks go down, and the buildings and machinery are not maintained; it is not realistic to try to put that facility back into operation quickly.

Mr. DYSON. I realize that. In fact, I have seen some of those places. We have one in Baltimore that fits that description rather well.

But what I am saying to you is, are there any plans—how would the Navy react in that kind of a situation?

Admiral HORNE. I think we would have to take that question for the record, sir. There are some studies and things that we may not be cognizant of.

Mr. **Bateman**. Would the gentleman yield?

Mr. **Dyson**. Yes, I'd be glad to.

Mr. **Bateman**. I think it is perhaps appropriate at this juncture in this context of questions to make reference to a statement made by General Glen Otis in August of this year in which he identified to a group of members from the Armed Services Committee his number one war-fighting need that was not adequately met was sealift. And when that comes from an Army general in a green suit, it seems to me that the United States Navy needs to perk up its ears and attend to the problem of sealift.

Admiral **Horne**. Yes, sir. I am just not the right person. We'll have to take that for the record. There may be some things, sir, that I am unaware of that we should put in the record for you.

Mr. **Dyson**. Mr. Chairman, I think my point has been made, so I'll wait to see what they submit for the record.

[The information follows:]

PLAN TO REACTIVATE SHIPYARDS

The Naval Sea Systems Command is not aware of any plans to reactivate shipyards. NAVSEA is nearing completion of a Production Base Analysis to identify the mobilization capabilities of shipbuilding and supporting industries. However, no specific actions to reactivate U.S. shipyards have been identified at this time.

Mr. **Anderson**. Fine. Mr. Pickett?

Mr. **Pickett**. Thank you, Mr. Chairman.

Admiral Horne, I appreciate your being here today.

How much of the Navy's repair and overhaul work is being done in foreign yards?

Admiral **Horne**. Really very little. There are some ships that are home-based overseas, not very many. And there are, of course, the voyage repairs for those ships. That's the sort of thing which is being done there. All of the scheduled overhaul work for all the other ships not based there is being done in the United States.

Mr. **Pickett**. So, there is no scheduled overhaul or repair work being done in the foreign yards at all. Is that right?

Admiral **Horne**. Only for those ships which are home-based there, and that is not a large number. They are scheduled for that. And of course, when ships transit and operate overseas in and around those ports and have emergency repairs, then, of course, they use those facilities.

Mr. **Anderson**. Would the gentleman yield?

Mr. **Pickett**. Yes, sir.

Mr. **Anderson**. I believe from my memory there are ships from my area home ported that are now being worked on in Subic Bay and in Japan. And they are being worked on regularly by these Japanese employees of the United States Navy and the Philippine employees of the United States Navy. They are American ships that are being repaired constantly.

Admiral **Horne**. Yes, sir. If they are home ported over there, yes, sir.

Mr. **Anderson**. There are ships that have been sent over there to be home ported, correct?

Admiral **Horne**. Yes, sir.

Mr. **Anderson**. Okay.

Mr. PICKETT. Admiral, there seem to be some 25 private yards capable of shipbuilding as opposed to the repair and overhaul. And I believe you said there are eight public yards at the present time?

Admiral HORNE. Yes, sir.

Mr. PICKETT. And it is the Navy's intention that all eight of the public yards would be kept in operation. Is that a part of——

Admiral HORNE. Yes, sir. Our strategic policy right now is to maintain certain capability in the public yards.

Mr. PICKETT. Is there any plan on the part of the Navy to try and maintain any of the private facilities in operation?

Admiral HORNE. Not directed at any specific facilities. There are things that are done in the bidding processes and in awards to try to maintain a mobilization base. And again, I am not an expert in this but some of the awards, I believe for the Aegis Cruisers and the 688 submarines, were split in such a way as to try to maintain more than just one shipbuilder.

There is concern to try to maintain as much of a capability as can be maintained. Of course, what happens is that one or two of the ships go to one builder and one or two of the ships go to another builder. So, that's the way that is generally regulated.

I think that is the major way in which that is done. Again, this is outside of my particular area.

Mr. PICKETT. In this plan that the Navy has to maintain an adequate industrial base for overhaul and repair, has the Navy taken into account what the requirements of sealift vessels would be?

Admiral HORNE. There have been some studies that have been made in that area, but I would have to refer that to the record. I am not sure what the plans are.

Mr. PICKETT. But you would agree that it is just as vital to keep the sealift vessels in operation as it is the fighting vessels?

Admiral HORNE. Absolutely.

Mr. PICKETT. You mentioned a moment ago that there is a gap in the amount of work available now and in the near term and that this is going to pick up in several years. There will be some more work available for the overhaul and repair yards?

Admiral HORNE. Yes, sir.

Mr. PICKETT. Is this primarily in the area of nuclear refueling, or is this in the standard repair and overhaul work?

Admiral HORNE. It turns out that our routine submarine workload is going to fall in phase with an increase in the number of nuclear surface ship overhauls and aircraft carrier work that has to be done starting in about 1993, 1992 and goes on for a few years. So, we are going to have a submarine, surface combatant, and aircraft carrier workload that falls together during that period.

Mr. PICKETT. I think I used up my time, Mr. Chairman. Thank you.

Mr. ANDERSON. Mrs. Bentley?

Mrs. BENTLEY. Thank you, Mr. Chairman.

Mr. Chairman, I ask unanimous consent to include a statement in the opening.

Mr. ANDERSON. No objection, so ordered.

[The prepared statement of Mrs. Bentley follows:]

STATEMENT BY HON. HELEN DELICH BENTLEY, A U.S. REPRESENTATIVE FROM MARYLAND

Acting Chairman Anderson and Ranking Minority Member, Mr. Lent, I commend both of you for calling this subcommittee oversight hearing together to review a serious problem facing the maritime industry, the decline of shipbuilding. Unemployment among our American shipyard workers is at an all time high.

According to the "First Report of the Commission on Merchant Marine and Defense", a major factor contributing to the decline of the maritime industry has been the virtual cessation of commercial ship construction in the U.S. This is a result of a world-wide surplus of both shipyards and merchant ships and America's inability to successfully compete in the world market.

The high trade deficit, poorly subsidized U.S. merchant industry, and high domestic labor costs contribute to America's inability to compete with foreign shipbuilding and repair industries.

I spend a large portion of my time and energy working to promote American industry. We need more Members committed to restoring America's industrial base.

Recently, I became disturbed over the U.S. Department of Defense spending U.S. taxpayers' dollars to repair ships by using foreign workers in U.S. shipyards. I immediately protested this ill-conceived policy by writing DOD and requesting the use of unemployed American ship repair workers. DOD has reduced the percentage of foreign workers repairing American ships, but I will not be satisfied until American workers make up 100 percent of the shipyard work force.

I look forward to receiving the testimony provided to the subcommittee here today and plan to work closely with my colleagues to prepare legislation to effectively address the problem of the decline in U.S. shipyard industry. I offer my full support to this important matter.

Mrs. BENTLEY. Admiral, I don't know where to begin to be honest with you. But I'll be nice.

Mr. Dyson said he has witnessed one yard. Actually, we have seen two yards in the Baltimore area close down. One is now a Toyota importing yard facility, and the other is going to be an apartment house complex. And we are struggling to keep the third yard alive.

Monies that are being spent now in the Persian Gulf by the Navy are monies that normally would have been spent on maintenance and overhaul, I believe, of ships. Am I right or wrong?

Admiral HORNE. I don't know that.

Mrs. BENTLEY. You don't know that.

Admiral HORNE. We are short of money in many ways. But I don't know specifically if that money would be used for maintenance. That's just not my area.

Mrs. BENTLEY. Are you aware that there have been any deferred maintenance and overhauls—those that would normally be scheduled now that they have been put off indefinitely or for a year or more of time?

Admiral HORNE. There are as a result of some of the recent cuts some overhauls or some maintenance which is being deferred. That is not firmed up yet because those things are just in the process of happening. So, I'm not sure. We know that we have less money, and we have not worked out exactly how that is going to impact specific ships. We have some ideas, and we are getting close to firming that up. But it depends on how all that comes out.

Mrs. BENTLEY. I would like you to include for the record, if you would please, a list of any overhauls and maintenance programs that have been deferred or have been laid over some time.

Admiral HORNE. I can give you what information that we have, yes, ma'am.

[The information follows:]

SHIP OVERHAUL DEFERRALS

The following is a list of ship overhauls which have been deferred in the last couple of years for financial reasons:

FY 1986: None.

FY 1987: None.

FY 1988: USS *Horne* (CG-30), USS *Worden* (CG-18), and USS *O'Brien* (DD-975).

All three of the FY 1988 deferrals were caused by a lack of Fleet Modernization Program funding required for the New Threat Upgrade and Vertical Launch System modernization packages.

In addition, SSN-699 was deferred from FY 1988 to FY 1989 for operational reasons.

Mrs. BENTLEY. What I have gathered here—and I am sorry I wasn't here for your whole statement, but what I have gathered from the questions that have been asked by my colleagues—because all of us are very concerned about this whole shipbuilding and ship repair situation—is that the Navy really hasn't made any plans for an emergency situation. If we have to break out all the RRF's today and tomorrow, how are we going to do it? I think they are on a 5- to 20-day breakout, aren't they? And how many of them do we have to do?

Admiral HORNE. Do you want to try to answer that?

Mr. TARBELL. I don't recall the exact number, but the studies that we have done indicate to us that, with the current shipbuilding and ship repair capacity that we have in the private and the public sector, we would have adequate capacity to activate the RRF as well as to accelerate the——

Mrs. BENTLEY. How many RRF's do you have to break out?

Mr. TARBELL. I'm sorry, ma'am. I don't know the exact number.

[The information follows:]

RESPONSIBILITY FOR RRF

The Maritime Administration of the Department of Transportation is responsible for planning and administration of Ready Reserve Force ships.

Mrs. BENTLEY. You don't know how many. Do you think you have adequate?

Mr. TARBELL. Yes, ma'am.

Mrs. BENTLEY. But right now you have had to bring over skilled workmen from other countries. Now, if you don't have the skilled workmen here now, how are you going to break those ships out in an emergency when you are going to have a bunch of them grouped together?

Admiral HORNE. There are different levels of skills. The studies that have been made to this point that I am familiar with, assume the ability to bring in a certain number of capable people from related industries in the private sector.

Mrs. BENTLEY. Are you sure that they are there? I am asking this for a reason. Are you sure that they are there?

Admiral HORNE. My personal knowledge that they are there—no, I am not sure they are there. The study indicates that they are there.

If you want my opinion, for the lesser complex work, some of which would be in the area of reactivation, that we will be able to draw some skills out of other industries in a national emergency, and this would be effective. For complex work, those weapon systems and sophisticated ships and the like in submarines and nuclear ships, I am not so sure we will be able to draw out those kind of skills. So, it will be a balancing situation.

I am frankly more concerned about the high tech skills. And by high tech, a machinist is nowadays a high tech individual.

Mrs. BENTLEY. What has the Navy done to encourage machinists training in this country?

Admiral HORNE. We have an extensive apprentice program in naval shipyards. I spend——

Mrs. BENTLEY. Wait a minute. Why is the Navy buying all of its machine tools overseas which is taking away from our machinist training in this country?

Admiral HORNE. That is out of my——

Mrs. BENTLEY. Well, I'm just going to tell you. The Navy has a lot of looking that it needs to do—the whole Defense Department—because the skill problem is a very critical problem in this country. And it isn't just at the shipyards. And I think you need to look at that. I am not sure that those skills are there because of the eroding industrial base of this country. And the Defense Department has helped contribute to that erosion, and the Navy has. And the Navy, in particular, is buying machine tools overseas. I think this is something that you need to look at in your whole scenario on what is happening in the skilled arena.

I am very serious on that because this has come up in several places. And I live at a shipyard. And I know what the story is down there.

Admiral HORNE. We are very concerned with the supplier base in all areas. There is no argument there.

Mrs. BENTLEY. Why are you buying machine tools overseas? Why are you buying containers overseas that require skills that we would have work in this country that would inspire young people to go into these trades and we would have some of these skills?

Admiral HORNE. I can't answer that specific question——

Mrs. BENTLEY. I would like it answered. On the record, I would like it answered. I would like all the questions answered.

Thank you, Mr. Chairman.

Mr. ANDERSON. We will keep the record open for your answers, if you would, on those questions. They are important questions.

[The information follows:]

PROCUREMENT OF MACHINE TOOLS AND CONTAINERS OVERSEAS

With regard to machine tools, the principal reasons cited by Navy contractors for their purchase of foreign machine tools are price, quality, and availability. It should be noted that the National Machine Tool Builders Association has reported recent increases in orders for United States machine tools, attributable to changes in the value of the U.S. dollar and improvements in both the quality and delivery of U.S. manufactured tools.

Foreign containers along with other items bought overseas are procured because of price and delivery capabilities.

Mr. ANDERSON. Mr. Bennett?

Mr. BENNETT. I appreciate the good work that the Commission has done. And I would like to ask a few questions which I am not sure have been addressed earlier in this hearing or not.

Is there an antitrust impediment to competition from abroad?

Admiral HORNE. I'm sorry. Would you repeat that?

Mr. BENNETT. Is there an antitrust law impediment to competition from abroad?

Admiral HORNE. I don't know the answer to that, sir. I'll have to take that for the record.

Mr. BENNETT. Is there somebody here from the Commission on Merchant Marine and Defense that can answer that?

Admiral HORNE. I don't know.

Dr. CAMERON. Yes, sir.

[EDITOR'S NOTE.—Allan W. Cameron, Executive Director, Commission on Merchant Marine and Defense, speaking from the audience. Dr. Cameron testified later in the hearing.]

Mr. BENNETT. It's prepared to do that.

Dr. CAMERON. It will.

Mr. BENNETT. I am not sure I shouldn't be asking my questions to the Commission.

But are there OSHA or wages or other labor aspects which are impediments to U.S. competition?

Admiral HORNE. I am not familiar enough with those aspects with respect to foreign competition. However, the OSHA requirements that we have and some other things in that particular area certainly can increase our costs. There are a lot of arguments in the industry. It is very subjective and hard to put your finger on. And there are a lot of arguments that some of these regulations actually end up, in the long run, reducing costs. We have a very serious problem in claims as a result of injuries, and that is increasing our costs. I am speaking of the public sector. I think the private sector is facing the same sort of problem.

Mr. BENNETT. Well, our OSHA requirements are stronger than those of any other country, aren't they?

Admiral HORNE. I would assume they are, sir.

Mr. BENNETT. If that's so, how could you help from answering my question yes? It costs money to comply with OSHA requirements.

Admiral HORNE. Yes, sir. My personal opinion is that they do increase the costs. Like I said, there are some arguments if it increases safety, it would decrease the cost.

Mr. BENNETT. Is the Commission addressing that aspect of the matter? Can I ask the Commission member to—I know this is irregular since you are not speaking for the Commission. You are speaking for the Navy. Correct?

Admiral HORNE. Yes, sir.

Mr. BENNETT. Is the Commission going to look into things like wage differentials and OSHA requirements and what the difference is between the two? I'm asking you.

Dr. CAMERON. Yes, sir.

Mr. BENNETT. All right. The third, are there subsidies or laws from foreign nations that present impediments to the merchant marine?

Admiral HORNE. Again, sir, I would have to take that for the record. I am not familiar with the subsidies of the merchant marine.

[EDITOR'S NOTE.—Reference a June 1988 report from the Maritime Administration, "Maritime Subsidies", which can be found in the Subcommittee files.]

Admiral HORNE. I assume the Commission will address that as well.

Mr. BENNETT. Are there other impediments that are known to you to competition between our merchant marine and abroad?

Admiral HORNE. I think the——

Mr. BENNETT. Or shipbuilding and abroad.

Admiral HORNE. If I had to point to one thing that I think is the biggest, it would probably be the wage rates. But, again, this is out of my area. I do not follow the foreign costs.

Mr. BENNETT. Well, why is it that the Navy does seem to be tempted to go abroad for Navy contracts occasionally like mine sweepers and things like that? Why do you go abroad?

Admiral HORNE. I would have to take that one for the record also, sir. I am not involved in that particular policy. That is at a level above me.

NAVY OVERSEAS SHIPBUILDING CONTRACTS

The Navy is not contracting abroad for building minesweepers. We have contracted with Intermarine SPA in Italy for design support of the MHC program. The lead ship of the MHC class is being built in Savannah, GA, by Intermarine USA, a U.S. shipbuilder. We are starting the process now that will lead to a second U.S. shipyard as the second source for this class.

Mr. BENNETT. Well, our product in our country is as good generally speaking as it is abroad, is it not?

Admiral HORNE. Yes, sir.

Mr. BENNETT. How about this question of contracting? You are in the Navy, so maybe this is more pertinent to the other questions I'll have. How about this question of fulfilling the appropriations rider on appropriation bills which has to do with competing private yards with public yards both in shipbuilding and also in airplanes?

I have never been able to figure out how a public yard can really compete in a contract with a private yard because their bookkeeping is so different and because of the fact that it seems to me to be a difficult thing to ever draw a contract with yourself. And thirdly, the thing that disturbs me is if a private concern comes in and competes against, say, a naval air rework facility or against a Navy shipyard, and gets the particular work that is to be done, I would think the shipyard or the naval air rework facility with its thousands of employees and its billions of dollars in capital investment would be virtually closed down. So, once you had somebody underbid you from the private sector, it looks like to me it would be very hard to justify keeping that facility with thousands of employees going. And so, wouldn't that allow the private sector to obliterate the Navy shipyard which was established to see that we had something going in time of war and have some competitive aspect between the two sides of our economy?

How do you answer what happens if you do let a contract to private enterprise that wipes out a naval air rework facility or wipes out a shipyard?

Admiral HORNE. I can't speak for the NARF's, the naval air refit facilities.

In the shipyards we only compete a certain percentage of the work.

Mr. BENNETT. Well, you let all the new work go into private yards at the present time I think.

Admiral HORNE. All of the new construction.

Mr. BENNETT. All of the new work.

Admiral HORNE. All of the new construction, yes, sir.

Mr. BENNETT. And 80 percent of the old work goes into public yards at the present time. But now you are going to compete that. What is going to be left of the shipyard?

Admiral HORNE. The rules are 70-30 percent on the repair and overhaul work.

Mr. BENNETT. I thought it was 80-20 percent. It's 70-30 percent?

Admiral HORNE. Yes, sir, 70-30 percent. We have been putting into the private sector about 36 percent, actually.

Mr. BENNETT. In other words, it is a growing thing because the figure I saw was 80 percent. You are now telling me it is 70 and it is working down to less because 36 percent is going in right now of the rework activity.

Admiral HORNE. Yes, sir, of the overhaul-repair work.

Mr. BENNETT. Well, eventually are we going to justify the billions of dollars of capital investment and the wages in the public yards and the public rework facilities? Are you going to be able to do that if you give all the work to private yards?

Admiral HORNE. No, sir, not if you give all of the work.

Mr. BENNETT. Well, a great deal of the work.

Admiral HORNE. Yes, sir.

Mr. BENNETT. It is moving in that direction rapidly.

Admiral HORNE. Yes, sir.

Mr. BENNETT. And somebody is going to eventually say why do we have billions of dollars invested in shipyards and naval air rework facilities when they are not doing any work. And then won't you close it? And then at that point it will be no longer competitive between the Government and the non-Government. You no longer have the Government base.

Admiral HORNE. Yes, sir. In my opening statement one of the things that I tried to point out was that there is not much flexibility left in putting work that is in the public shipyards into the private sector because of the nature of that work. We are down to almost all nuclear work and some very high tech work for which only some private shipyards can compete. But the market is a lot more limited than——

Mr. BENNETT. Does the Navy like that provision of the appropriations law which says that you have got to compete between the public and the private sector? And if so, what is the justification for it? I am not sure you like it. I am hoping you don't because I don't like it. I am trying to let you know how I feel, but say what is on your heart.

Admiral HORNE. Well, it's a two-edged sword. We have definitely seen some motivation toward some efficiencies as a result of it. I think we are probably going to end up seeing some decreased overall cost as a result of it.

However, as you mentioned, if you carry it to extremes, with the amount of work that we have available some of our more highly capitalized shipyards and all are going to be hurt. And that presents us with a problem. So, there are some advantages. And if we are going to use competition, it has to be done in a surgical manner and not just opened up too much.

Mr. BENNETT. Well, that provision of the appropriations bill is more of a threat to the Navy and its ability to operate than it is to private industry, isn't it?

Admiral HORNE. I had that opinion when we started the competition. However, the Navy shipyards have ended up not doing very badly when they compete against highly capitalized shipyards. They have been winning some of the more high-ticket contracts, and they have lost the low-ticket contracts for the surface ship-type work.

Mr. BENNETT. Suppose that all underbid and so all the contracts go to private shipyards and private airplane repair. Suppose that happens. What would the logic be for keeping the shipyards open and operable?

Admiral HORNE. You wouldn't be able to keep them. If we opened up——

Mr. BENNETT. Well, is there any thought being given to that aspect of it and how you would protect against that happening?

Admiral HORNE. Yes, sir. As I said, we want to maintain a core capability. So, for the ships which are designated for competition, we are trying to hold that number down to an amount that will not jeopardize the core and still have the benefits of the competition itself decreasing the cost.

Mr. BENNETT. Thank you.

Mr. ANDERSON. Thank you, Admiral Horne and Mr. Tarbell, for your presentation.

Our next witness is Bill W. Thurman, Deputy Director for Planning and Reporting, National Security and International Affairs Division of the General Accounting Office. He will be accompanied by John Landicho, the Senior Associate Director for the Navy Subdivision.

Mr. BATEMAN. Mr. Chairman?

Mr. ANDERSON. Yes, Mr. Bateman.

Mr. BATEMAN. Mr. Chairman, before the next panel begins, I would like to reserve the right with unanimous consent to pose some questions for the record with reference to the public-private competition matter that Mr. Bennett was inquiring into. Thank you.

Mr. ANDERSON. Now, Mr. Thurman. We do have your prepared statement. Your prepared statement will appear in the record. You can extemporize, read, any way you wish.

STATEMENT OF BILL W. THURMAN, DEPUTY DIRECTOR FOR PLANNING AND REPORTING, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY JOHN LANDICHO, SENIOR ASSOCIATE DIRECTOR, NAVY SUBDIVISION, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION

Mr. THURMAN. Thank you, Mr. Chairman. I have a fairly short statement, and I realize you are pressed for time. I will go through and hit the high spots in that statement and then respond to any questions that you might have.

First, let me say that we are pleased to be here with the Subcommittee this afternoon to discuss our recent report which was done at the request of the Subcommittee on Defense of the House Committee on Appropriations dealing with the issue of Navy ship construction contracts and the possibility of claims under some of these contracts.

We reviewed 22 fixed-price incentive contracts which were competitively awarded over the past few years. The contracts covered some 69 vessels involving nine combatant and non-combatant ship programs at 10 private shipyards. Our review showed that the Navy policy of competing ship construction contracts had generally resulted in lower and declining contract prices. However, at the completion of our work in about July of this year, the Navy was projecting cost overruns totaling about $1.4 billion or about 16 percent over the target cost for 19 of the 22 contracts that we examined.

On fixed-price incentive contracts, as I am sure this Subcommittee is aware, the Navy shares a portion of overruns. Normally, that sharing is 50 percent of the overruns that are in excess of target cost up to a pre-established ceiling price. If final costs come in at the estimates that existed in July, the Navy will have to fund about $706 million of the overruns under the contracts that we examined.

Costs above the ceiling prices are borne entirely by the contractor. The estimated completion costs for a number of the 22 contracts we found were close to, at, or above the ceiling price. Specifically, nine contracts had estimates of at least 90 percent of the ceiling cost and four were projecting costs at or above the ceiling.

In April, we testified before the Defense Subcommittee of the House Appropriations Committee and reported that five of the 22 contracts were underrunning target costs by about $60 million. By July, however, this had changed, and only three contracts were projected to underrun their target cost. The projected underrun was $26 million. When costs are underrun, such as these, the savings are shared equally by the Navy and the shipbuilders.

The causes for the projected overruns are many and varied. But, if one can generalize about a systemic cause, it is a result of shipbuilders' decisions to cut prices and to make low, competitive offers in order to obtain Navy contracts.

Our analysis of the contracts showed that some of the proposed prices were identified by the Navy at the time of the award to be optimistic. In other words, the proposed prices were below the Government estimate, and the Navy believed that they presented a certain risk of cost overrun.

As part of our work, we interviewed five shipbuilders to obtain their views on the current business environment existing in the industry. There was a general agreement—and I am sure it is not surprising at all to this Subcommittee—that the industry is currently very much in a "low ball" or close to the margin profit environment on Navy ship construction contracts. Although the shipbuilders supported the competitive process and fixed-price contracts for follow-on ships, they were concerned about the long-range effects of the Navy's emphasis on price competition on their weak industry. In their view, or at least in some of their views, the competitive environment for shipbuilding forces them to bid aggressively for limited work because price, as the Admiral mentioned, was the Navy's driving factor in making award decisions.

I should note at this point that there is absolutely nothing to prevent an offeror from reducing its prices for competitive purposes. As long as the proposal to the Government is technically acceptable and the contractor is determined to be responsible, the contract may be awarded to that offeror. The Government contracting officer must, however, take steps to assure that follow-on contracts or change orders are not used to recover low cost bids.

I should also note that, although price was the heaviest weighted factor in all of the 22 contracts that we examined, the Navy in its evaluation of the offers did consider other technical and management factors. Where necessary, pre-award surveys were performed by the Navy, and in all cases the Navy made a determination that the successful contractor was responsible and capable of delivering under the contract for which it was being considered.

Finally, where there are significant contract cost overruns, I think the 1970's taught us that the likelihood of contractor claims against the Government or request for equitable adjustments, the so-called REA, is increased. An REA is a request for monetary payment or an extension of the delivery schedule or both which is not in dispute at the time the Government receives it. Whenever a dispute cannot be settled by this type of agreement, the contractor may file a claim relating to the dispute. As of July 1987, contractors were, according to the Navy, attempting to recover or anticipated submitting either REA's or claims for eight of the 19 contracts that were projecting cost overruns.

The Navy has policies and procedures in place to prevent and avoid claims. These measures basically are implemented by the SUPSHIP activities or field installations that the Admiral described earlier which are responsible for administering and overseeing the execution of the contracts. All of the SUPSHIP activities that we visited during the course of our work had active programs under way to try to avoid claims against the Government.

In summary, Mr. Chairman, the message that we drew out of our work was that over the past few years the U.S. shipbuilding industry—faced with a weak and declining commercial market—has been intensely competing for limited Navy ship construction work. And, while the highly competitive bidding on Navy contracts has produced favorable contract prices, it is contributing to cost overruns that could present future problems to both the shipbuilders and the Navy.

That concludes a synopsis of my prepared statement. We would be happy to respond to any questions, Mr. Chairman.

[The prepared statement of Mr. Thurman may be found at the end of the hearing.]

Mr. ANDERSON. Thank you, Mr. Thurman.

Your analysis showed that, while price was the most important factor in the procurements that you studied, the Navy considered other technical and management factors. What were the other factors, and how important were they in the award of the contracts?

Mr. THURMAN. Generally speaking, Mr. Chairman, as you accurately portrayed it, price was the governing factor, but there are other factors such as the need to maintain the defense industrial base. The Admiral mentioned earlier in the case of the class 688 submarines some conscious decisions have been made in that program to maintain two shipbuilders capable of producing that ship. So, that was one factor.

Managerial competence is another consideration. Delivery schedule, the capability to meet the Navy's required delivery schedule, is a third factor that comes to mind. A fourth is the financial responsibility of the company that is being considered for a particular award. But, again, the basic policy over the past few years has been to place emphasis on the price offered by the competing shipbuilders.

Mr. ANDERSON. How about quality? Shouldn't quality be something there?

Mr. THURMAN. Yes, sir. That's definitely——

Mr. ANDERSON. It seems to me that when you build a Navy ship, you want the best ship built, not just the cheapest, but the best.

Mr. THURMAN. Yes. We agree totally and that is certainly considered.

The Navy basically deals with a core of the same shipbuilding companies, and the quality performance record that these shipbuilders have established is very well-known to the Navy through its oversight activities at the SUPSHIP level.

Technical competence and technical capability are definite concerns. There is no question about this.

Mr. ANDERSON. Mr. Biaggi?

Mr. BIAGGI. I referred to the situation where you have contractors bidding just to get jobs in the yard irrespective of the margin of profit. There seems to be a mandate within the Navy concerning dollars. I imagine that runs through a number of the services, and it has to have an impact.

But what conclusion can you arrive at if the Navy continues to have that lowball or marginal estimate and you have shipbuilders who keep coming in knowing that they are probably not going to make money or just barely survive? What do you see long range?

Mr. THURMAN. Well, Mr. Biaggi, if——

Mr. BIAGGI. For the record. I see it in my own mind, but I would like it for the record from you.

Mr. THURMAN. Well, I would like to go back to one of the comments that you made at the start of your question about the emphasis on price. I don't think there is any question that throughout the Department of Defense—and I believe, generally, this has been very salutary—there has been an emphasis during the 1980's on obtaining competition. In large part, this is in response to the Competition in Contracting Act which the Congress enacted in 1984. If you take a look at the statistics, the percentage of competitive awards DOD-wide in fiscal year 1985 was in the neighborhood of 40 percent. In 1986, it had moved up to in excess of 50 percent. So, the trend to increased competition is very much in place.

I hope that that is not being done—although, clearly, we face a difficult situation with the shipyards—possibly at the expense of quality.

Mr. BIAGGI. Excuse me. I recall Admiral Horne's words.

Mr. THURMAN. Yes.

Mr. **Biaggi**. There wasn't too much of a material difference——

Mr. **Thurman**. In the quality?

Mr. **Biaggi**. Right.

Mr. **Thurman**. Yes. Yes, sir.

Mr. **Biaggi**. Well, you know, that's a qualified response.

Mr. **Thurman**. We have not done a study focusing specifically on the quality of ships being delivered. So, I am not in a position to give you a factual answer on that issue.

Although GAO has not done a study of the entire maritime industry, it seems to me, fundamentally, that what we are faced with in this area is an industry that was built up over the years to handle a much larger private sector than exists today. Shipbuilding in the private sector has declined—as noted in the statistics that you cited in your opening statement. It seems to me the salient point to consider if you look at the Navy's award patterns on at least a couple of major programs that come to mind—is to maintain sufficient capability to assure that the needed naval ships are constructed. If you look at the cruiser program, clearly, there are some industrial base considerations going on in those awards to keep two shipyards involved in constructing those vessels. The same can be said of the 688 class nuclear attack submarine.

I am not giving you a profound answer here because I am not sure that we know one in terms of the long haul. But it seems to me, clearly, what we have got is a supply capability that exceeds the demand for production. And that is very, very tough to deal with. I think we all see the agony that is involved in that process.

Mr. **Biaggi**. Well, we see the agony. We should look for the solution.

Mr. **Thurman**. The solution, yes.

Mr. **Biaggi**. And the participants in the potential solution are not forthcoming. That's the answer. Until we change the policy of this country, we will continue in the manner in which we are going.

Mr. **Thurman**. The work that the Merchant Marine Commission is doing strikes me as some very good work in terms of laying out the issues. The Commission's initial report clearly linked the difficulties with meeting some of our defense needs with the decline in the maritime industry. Obviously, all of our defense requirements will never be satisfied totally. We are faced with some very, very difficult tradeoffs, particularly with more constrained defense budgets, as the Admiral said.

Mr. **Biaggi**. I agree that we never have full satisfaction of our defense requirements. I think another message comes through from the Admiral's testimony, and the give and take here today. It is more than the fact that we are not fully up to par. We don't have the surge capability for national defense. No one has disputed that.

I see at least a replication of the circumstances that confronted this country in 1942. It is astounding.

But I would like to take this occasion to compliment our colleague, Mr. Bennett, for his initiative on the Commission. We know the Commission's report is excellent.

Mr. **Anderson**. Mr. Saxton?

Mr. **Saxton**. Thank you, Mr. Chairman.

You mentioned, Mr. Thurman, that you had 22 case studies of contracts.

Mr. THURMAN. Yes, sir.

Mr. SAXTON. Can we know what contracts they were?

Mr. THURMAN. Yes, sir. We can provide a listing of those contracts to you. Some of the financial data associated with the individual contracts is proprietary and would have to be protected.

[EDITOR'S NOTE.—This proprietary data was supplied directly to Mr. Saxton.]

Mr. SAXTON. In your individual case studies of the 22, did you then break down the component parts of the process of building a ship in terms of systems that might be in a ship and the contracts that are let by perhaps a general contractor?

Mr. THURMAN. No. We were looking, Mr. Saxton, at the prime contract award itself—the fixed-price incentive contract that was awarded to the shipbuilder. So, we did not examine the subcontract agreements, but their costs have a direct bearing on the financial data.

Mr. SAXTON. In terms of an Aegis cruiser, would you look at the Aegis system separately from the total ship?

Mr. THURMAN. No. We looked at the ship. We looked at the hull. Correct, John?

Mr. LANDICHO. That's correct.

Mr. THURMAN. Yes. We did not look at the Aegis system as part of that work. In other words, we were looking at the basic hull that Bath Iron Works or Ingalls Shipbuilding is delivering, and the Aegis is separate from that.

Mr. SAXTON. So, the Aegis system would not have been even a part?

Mr. THURMAN. No, sir. It would not be part of the cost numbers that I cited. The value of the contracts that we examined was something on the order of about $10 billion, but that was for the hull itself.

Mr. SAXTON. All right then. Thank you.

Based on what you have seen, do you think that Congress has some need or reason to reassess the process that we go through that it has been established?

Mr. THURMAN. The competitive process? Is that what you are referring to, sir?

Mr. SAXTON. Yes, sir.

Mr. THURMAN. We should think long and hard about that. It is very difficult in Government procurement to think of anything better than competition in terms of assuring not only a reasonable price, but more innovative products.

If you look at some of the efforts that other branches of the military have under way—I am thinking here, for example, of the LHX program in the Army—the acquisition strategy that the Army is attempting to follow is one that is designed to bring forth the best technology possible for a new group of helicopters. The LHX acquisition strategy is very much a competitive process.

So, at this moment, I cannot make a specific suggestion for a better way to go given the manner in which our military industrial complex operates. At the same time, I think all of us can see some difficulties that are produced by competition every once in a while.

Mr. SAXTON. In your testimony you mentioned requests for equitable adjustments and cost overruns.

Mr. THURMAN. Yes, sir.

Mr. SAXTON. In light of those, how does the balance sheet turn out? Have we helped to reduce the total cost?

Mr. THURMAN. That's an excellent question, Mr. Saxton, and one that we are going to have to wait until all the numbers are in before any of us know. Clearly, this is one of the items that has been of concern to our staff. It could be that even though the current costs of some of these vessels are less than that estimated, that at the end of construction some of these costs may be affected by subsequent cost overruns and claims.

Mr. SAXTON. I think that is the bottom line. Those are the conclusions that, hopefully, you are going to reach in your study I would think.

Mr. THURMAN. Yes. We will continue to monitor this very closely as it proceeds.

Mr. SAXTON. Do you have a time line as to when you may be reporting to Congress in terms of those types of conclusions, or at least suggestions, recommendations, perhaps not conclusions?

Mr. THURMAN. Let me defer to Mr. Landicho on that question.

Mr. LANDICHO. We are on standby. The best way to put it, Mr. Saxton, is that we are planning to do a follow-on assignment to monitor this issue. Now, we are on the same time line as last year, and the status of this issue would be supplied in April 1988 and then followed by a formal report. So, we are on the same time line Mr. Thurman pointed out.

One of the things that we will have to do and will do is track the status, if you will, of the REA's and claims and just where they stand at that point in time. At the time we did our work, there were indications that firms might come in with either requests for equitable adjustments or claims. And since that time I know that one REA has been sent to the Navy, and others are still pending. This was based on information about a week ago.

Mr. SAXTON. Is it too early in your study to see a trend though? Can't you predict that a system appears to be working or a system is lacking in certain areas just from what you have studied and seen so far?

Mr. LANDICHO. Well, the best way I can express it, Mr. Saxton, is this very study gave us the baseline. It also gave the baseline I believe, to the Subcommittee on Defense to know the extent of the cost growth and the extent that the Government is liable—about half that cost growth.

Mr. SAXTON. Thank you, Mr. Chairman.

Mr. ANDERSON. Mr. Lowry?

Mr. LOWRY. Thank you, Mr. Chairman.

Just to continue right on, as I read your report—and I congratulate you on the initial amount—I read 19 of the 22 had cost overruns.

Mr. THURMAN. Yes, sir. That's correct.

Mr. LOWRY. That's a pretty high batting average, it seems to me; 19 of 22 is obviously a pretty significant problem or question.

Mr. THURMAN. Yes, sir, it is.

Mr. LOWRY. And about $1.4 billion just on those 22 contracts.

Mr. THURMAN. Right.

Mr. LOWRY. Moving on to completion of the study, in the cost estimate stage, if we don't take into account the quality of the workmanship and thereby discover what the real maintenance costs are going to be on this vessel's service over the length of the service of the vessel, how do we know the real costs?

Mr. THURMAN. Mr. Lowry, that is an excellent question. Let me respond to it this way. In our work at the SUPSHIP activities, we did find some concern—I am going back about a year or so now—about the level of staffing that those activities had to oversee and do the kinds of inspections that needed to be done as the work was proceeding. Since that time, I think it is fair to say—and please correct me if I am wrong, John—that the Navy has moved to address some of those staffing imbalances. And most people that we talked to who carry out the inspections and do the day-to-day work seem to be reasonably satisfied with the quality of product that the Nation's shipbuilders are delivering today. So, we didn't detect indications during the course of this work of any major quality difficulties.

Mr. LOWRY. I wonder, as to the REA's and cost overruns, how much relationship there is to the increased oversight inspection by the Navy as we are going through the shipbuilding as to the cost overrun and to the quality. And I do want to say that is a question. I have at least been told by many private individuals working within the shipyards, actually skilled workers within the shipyards, of real concerns about quality.

Mr. THURMAN. As one who has spent a long time looking at defense procurement and products and so forth, I would be the last to argue that our products are perfect. We have seen serious quality problems. In fact, we have reported recently on fairly serious quality problems, for example, in missile programs. So, my response to you, Mr. Lowry, was at a much more macro level.

Mr. LOWRY. Sure, of course.

Mr. THURMAN. You know, there is no question that we have quality difficulties in this country. I don't want to minimize them at all.

Mr. LOWRY. Of course. And I know that gets at a lot more micromanagement—my question—than you were here to answer at this point. I appreciate that.

Under the existing law or regulations in which the Secretary of the Navy—in which the decisions are made on the awarding of contracts and our concern about the low-balling effect of awarding contracts relative to the rest of this question, does the Secretary of the Navy have the latitude to make the decisions as to quality and so on under the existing regulations and bringing in the other factors besides just the low-ball bid?

Mr. THURMAN. Yes, sir. That authority definitely exists. In fact, procuring activities have generally very wide authority in considering such factors.

The difficulty that one obviously faces here—if I am contractor A and you are contractor B and we are both deemed to be technically capable, managerially capable, and financially capable of delivering a submarine, a cruiser, a destroyer or whatever—if I find out that you got the contract because a Navy analyst thought that my proposal was too low, I think I would file a bid protest with GAO. I think this is the dilemma one is faced with when a request for proposal goes out that states that price will be a driving consideration provided all other things are equal. The Government would need a very strong case to back away from that.

Mr. LOWRY. Yes. Just a last question on that line, Mr. Chairman.

How much of a factor has the Navy been taking into account, the quality of the skilled workmanship in making that real decision as to what the quality of the ship is going to be?

Mr. THURMAN. Quite honestly, I could speculate with you, but that is what it would be. We have really not addressed that question, Mr. Lowry. We know from talking with people who are involved in the award process that the technical ability of the contractor and the quality of its work force is taken into account just from the day-to-day workings between SUPSHIP and the contractors. But we have not specifically examined that.

Mr. LOWRY. Well, not to beat around the bush, I think in cases where you have an experienced work force which might very likely be working under a labor wage scale based upon their experience and so on, versus going out to some other shipyard that isn't using that kind of——

Mr. THURMAN. That's an unknown.

Mr. LOWRY [continuing]. Experienced work force——

Mr. THURMAN. That's an unknown. Yes.

Mr. LANDICHO. I would just like to add to what Mr. Thurman referred to earlier that the bulk of the shipbuilding really revolves around four large shipbuilders. From that point on, there are other smaller shipbuilders. Now, to the extent they are new to the Navy, the Navy can insist on having a pre-award survey. The Navy can form a team headed by somebody at the Naval Sea Systems Command level assisted by personnel of the Supervisor of Ships located in various parts of the country to go in to that particular shipyard and survey it from a technical aspect, from a financial aspect, and so forth before making a decision to have them in the program or not. But I agree with you, Mr. Lowry, that technical ability and all that could be proven or demonstrated over time.

Mr. LOWRY. Thank you, Mr. Chairman.

Mr. ANDERSON. Mr. Bateman?

Mr. BATEMAN. Thank you, Mr. Chairman.

Of the 19 of 22 contracts that you surveyed that are running above the anticipated cost, are we talking about the target price, or are we talking about the ceiling price being exceeded?

Mr. THURMAN. Target cost.

Mr. BATEMAN. Target cost?

Mr. THURMAN. We are talking about target cost.

Mr. BATEMAN. Can you tell me how many of the 22 exceed the ceiling price?

Mr. THURMAN. Only two contracts exceeded ceiling, which means that, assuming that the estimates are correct, that those contracts are in a loss position. And then two others are at ceiling. All of these contracts, Mr. Bateman are still under way, and some of them have delivery dates quite far into the future. This is basically what we are dealing with. We are talking about the target cost and not the ceiling price.

Mr. BATEMAN. So, the 19 of 22 is not as egregious as it might appear at face value.

Mr. THURMAN. No, sir.

Mr. BATEMAN. Okay.

Mr. THURMAN. But, as you know, any cost above the target cost is shared 50-50 between the Navy and the shipbuilder. If the target cost is underrun, the savings are shared on a 50-50 basis.

Mr. BATEMAN. Are all of these 22 contracts in the private sector in the private yards?

Mr. THURMAN. Yes, sir.

Mr. BATEMAN. Is that because that was the mandate of your study? Why not an inquiry into cost overruns in the public yards?

Mr. THURMAN. It was the mandate of the study. We were asked to look at the question of whether or not it appeared that we were headed for a situation where claims like we had in the 1970's would be returning and the realism of some of the private sector proposals that we were getting.

Mr. BATEMAN. Do you have any feel for whether or not the cost of the Aegis equipment, gadgetry, installed in the Aegis ships is experiencing cost overruns and whether or not they are comparable to the hull and shipbuilding component?

Mr. THURMAN. We will have to submit that for the record for you, Mr. Bateman.

Mr. BATEMAN. Well, if you don't have it, don't go out and launch a new investigation.

Mr. THURMAN. It should be relatively easy to obtain that data for you.

[EDITOR'S NOTE.—GAO advises that this is proprietary information.]

Mr. BATEMAN. At any point has there been a focus on a phenomenon of some genuine concern to me that in the public-private competition as it has been implemented in the context of nuclear submarine overhaul that we have lost the last private capability for performing that work?

Mr. THURMAN. If I am following your question right, there is only one private yard that is certified to do the most complex nuclear work. Maybe I ought to defer to Mr. Landicho here.

Mr. LANDICHO. Yes. The capability—in terms of the competitive field—is that we have six public shipyards that can do the overhaul in the nuclear area, whereas you have one on the private side.

Mr. BATEMAN. Well, what I am focusing on is that, while there has been but one that is certified to do it in the private sector, that one is no longer willing to play the ball game.

Mr. THURMAN. I am not sure we have any information on that yard backing away from competing.

Mr. BATEMAN. Okay, thank you.

Mr. ANDERSON. Mrs. Bentley?

Mrs. BENTLEY. Thank you, Mr. Chairman.

Mr. Thurman, if in evaluating two proposals, it is noted that one is better technically and the other is lower cost but poor technically, which would get the contract?

Mr. THURMAN. Mrs. Bentley, I am not sure—and I will ask Mr. Landicho to correct me if I am wrong here—I am not sure that the Navy was faced with that question in any of the 22 contracts that we examined. So, I think it is a hypothetical question. And I will have to answer it in hypothetical terms.

If the technical proposal is so deficient that the Navy is convinced that the yard could not deliver the ship that it needed in time, that could take precedent over price. But again—my response is a hypothetical one—because I just don't think that occurred in any of the awards that we examined.

Mrs. BENTLEY. When you are lining up and giving your points toward the contract award, how does technical capability compare with the cost in a contract award?

Mr. THURMAN. I am not sure I can answer in terms of percentages.

Mr. LANDICHO. We don't have any percentages. But we clearly state in the report, Mrs. Bentley, that the highest weighted factor was indeed price, and technical and other things were weighted less than price.

Mr. THURMAN. I don't think that there is a general rule that we could lay out that would be explicitly followed in every case. For example, typically, what you find is those companies who are capable of producing a particular ship are the ones that are active in the proposal. It would be unusual for an unknown new firm—in fact, I am not sure it has ever happened—to come forward and bid on a cruiser, for example.

Mrs. BENTLEY. Well, yes, a cruiser.

Mr. THURMAN. So, you are dealing with——

Mrs. BENTLEY. But there are a lot of other Navy contracts out there besides cruisers.

Mr. THURMAN. Yes, ma'am. But the ships that we primarily focused on here are the larger combatants.

Mr. ANDERSON. If you would like, we will keep the record open so you can have that correct for the record.

Mr. THURMAN. All right. Yes, sir.

Mr. ANDERSON. No objection, so ordered.

Those are the second bells.

Mrs. BENTLEY. Okay, I'll just have two more questions quickly.

When you are making your comparisons or you are studying your contracts, do you compare what the bid price was and then what was the closing price, what was the final price, and what goes in to either raise the final price or to reduce the final price?

Mr. THURMAN. Yes, ma'am. Basically, at this point, all of these contracts that we are talking about are under way. And what we are looking at is cost performance to date and cost forecast through completion. For example, if you are a third of the way through on a particular hull—what did you estimate the cost would be at that particular point, and what is it looking like now, and what is the forecast for the future? Those numbers are then compared against the target cost and the target profit and the ceiling price.

Mrs. BENTLEY. You are talking about competition. Don't you think competition is necessary? I don't think any of us really disagrees with that.

However, do you think that the Defense Department should be allowing foreign contractors to come in and bid? I am not just talking about Navy work. I am talking about any kind of defense work.

Mr. **Thurman**. I am not an expert on this, and I need to make that qualification on my comments at the start.

One of the things that we have entered into with our NATO allies is the so-called "two-way street," arrangements where they buy defense articles from us, and we seek opportunities to buy from them.

You may recall there was quite a controversy here a year or so ago surrounding the Army's award of a handgun contract to Baretta which is an Italian firm. So, there has been some limited use of foreign source defense suppliers. The Army's MSE contract for communications equipment is another example that comes to mind.

Most of those are done under the umbrella of the two-way street arrangements because our country has been under considerable pressure from our allies. They are basically saying we buy a great deal of our defense supplies from the United States and we would like to see some reciprocity.

I don't pretend to be an expert in that area though, Mrs. Bentley.

Mrs. **Bentley**. Unfortunately, the reciprocity all works one way.

Mr. **Thurman**. Sometimes it seems that way.

Mrs. **Bentley**. We don't insist on reciprocity the other way such as free trade and fair trade.

One other thing. Some of this was brought up during questioning with Admiral Horne, and that has to do with skilled personnel being available.

Mr. **Thurman**. Yes, ma'am.

Mrs. **Bentley**. Are you finding that in the contracts where the price is going up that perhaps they have had to redo the work more than once because of the lack of skilled personnel?

Mr. **Thurman**. I don't know that we can tie it to that specifically. We have observed things like anticipated learning curves and efficiencies that were not, in fact, achieved as the work proceeded forward, which may well be attributable to the circumstance that you are alluding to. But to be candid, our work did not go that deep, Mrs. Bentley.

Mrs. **Bentley**. Mr. Chairman, I would request unanimous consent to submit some questions to him and also additional ones to Admiral Horne, if I may.

Mr. **Anderson**. No objection, so ordered.

Mrs. **Bentley**. Thank you.

Mr. **Anderson**. I think we better recess here. Thank you, Mr. Thurman and Mr. Landicho, for your presentation.

At this time we will be in recess for about 15 minutes. We are already past the second bells.

[Recess.]

Mr. **Anderson**. The subcommittee will come to order.

Our next witness is Allan W. Cameron, the Executive Director, Commission on Merchant Marine and Defense. And Dr. Cameron, we have your prepared statement. Your prepared statement will appear in the record. You can read, extemporize, present it any way you wish.

STATEMENT OF ALLAN W. CAMERON, EXECUTIVE DIRECTOR, COMMISSION ON MERCHANT MARINE AND DEFENSE

Dr. CAMERON. Thank you very much, Mr. Chairman.

Mr. Chairman, it is a pleasure for me to be here this afternoon at the direction of the Chairman and the Commissioners to present the findings of the Commission on the current and projected capability of the United States shipbuilding and ship repair industries.

On behalf of the Commissioners, sir, I appreciate your kind remarks, as well as those of your colleagues on the Committee about their report.

On October 19 of this year, the Commissioners personally presented their first report to the President. The report was also presented formally to Congress, and copies were provided to each Member. My statement is based substantially on the contents of that report and on the detailed information contained in the appendices to it. What I intend to do orally is to hit the high points for you.

Last month, the Commission also published the proceedings of the six public hearings that it held earlier this year. Copies of that substantial volume were also distributed to the Congress, as well as to other interested groups and individuals. You will note, Mr. Chairman, that one hearing was on the ship construction and repair industry, and that another was on the supplier industries, the industrial base, if you will, for the maritime industries of the United States. The Commissioners believe that the record of their hearings is an important and useful document about the status and prospects of the American maritime industries today.

The first report of the Commission begins with the following general conclusions: "The Commission has found clear and growing danger to the national security in the deteriorating condition of America's maritime industries. The United States cannot consider its own interests or freedoms secure, much less retain a position of leadership in the free world, without reversing the decline of the maritime industries of this Nation, which would depend so heavily in a protracted war upon adequate use of oceans for its military defense and for its economic survival."

The Commission believes that sealift is absolutely essential to the success of our national military strategy and to the execution of our military contingency plans. The Commissioners believe that the problem of providing sufficient strategic sealift, including shipping to meet economic support requirements in time of conflict, is a national problem, not a problem only of some industries or some Government agencies. As a national problem, it requires a national solution.

Based on its study and analysis, the Commission has concluded that there is no more militarily efficient, cost effective, and reliable way to provide the majority of the military sealift requirement now and in the future than through an active United States-flag merchant marine. The ships should be militarily useful and operating, engaged in peacetime in carrying commercial cargo and manned by United States crews.

The Commission believes that, in principle, there is no reason that there cannot be a commercial merchant marine adequate for national security needs. The data show that the volume of United States oceanborne foreign trade is substantial and increasing, but that the United States-flag merchant marine carries only a small portion of it, and has not been able to increase or even maintain its proportional share as the overall amount of cargo has increased.

Most United States imports are carried on foreign-flag ships. According to the Department of Commerce, in 1986 American importers, and ultimately American consumers, paid out $9.1 billion for the transportation of goods imported into the United States on foreign-flag ships, an amount that is likely to increase substantially in the future.

Similar figures for exports are not available since the costs are paid by importers and consumers in other countries, but most American exports were also moved on foreign bottoms.

The maritime industries have been in a state of decline for many years, but the rate of decline is now increasing at an alarming rate. Some of the largest ship operators, shipyards, and shipyard suppliers have gone out of business, and most of those that remain face serious financial hardship. The Commission's analysis shows that unless actions are taken to reduce the downward trend, the number of merchant ships and seamen will be reduced by one-half by the year 2000. Similarly, the shipbuilding and repair industry will continue to shrink and will be almost totally dependent on Navy work for its very existence.

A major factor contributing to the decline of the shipbuilding industry has been the virtual cessation of commercial ship construction in the United States. In 1980 there were 69 merchant ships under construction in 15 different American shipyards. Today, there are none. That situation is directly attributable to a worldwide surplus of both shipyards and merchant ships, to the inability of United States shipyards to compete in terms of price with most foreign shipyards, to little coastal or inland maritime work, to the collapse of the offshore energy industry, and to the failure of the construction-differential subsidy and other Government construction assistance programs.

In an average year during the 1970's, 25 commercial ships were ordered from American shipyards. In 1973, in fact, 43 commercial ships, totaling over 1.9 million gross tons, were ordered. Since 1980, there have been only 28 ships ordered, and no new commercial ship orders have been placed with American shipyards for well over three years. Only nine shipyards are now building ships greater than 400 feet in length, and all of those ships are for the Navy.

Today, for probably the first time in American history, there is not even one oceangoing merchant ship under construction in a United States shipyard. There are, however, 11 merchant ships under construction for U.S. ship operators in foreign shipyards, along with four oil rigs, for a total of 15 vessels.

The total collapse of commercial ship construction has been a major factor in the decline of United States shipbuilding capability. Government construction alone, mostly Navy and concentrated in a small number of shipyards, is insufficient to maintain a diversified shipbuilding and repair industry, including shipyard suppliers, adequate to meet mobilization requirements in time of war or national emergency.

During its study of the maritime industries, the Commission found that, after operating for years with minimal capital investment, annually inflating labor costs, over-capacity, slow technological development, and marginal productivity under sole-source negotiated contracts, many shipyards have experienced a complete about-face. Hundreds of millions of dollars each year have been invested in capital improvements. Virtually every yard has adopted computer-aided design and manufacturing technologies. Weak markets have eliminated marginal shipyards and over-capacity. Labor costs have been stabilized or reduced. Virtually every contract award has been the result of aggressive fixed price competition. Because of efforts by both labor and management, the waste and inefficiency formally found in the American shipbuilding and repair industry are largely disappearing.

Those gains, however, have taken place at the same time as the industry has been declining precipitously.

Due primarily to the significantly reduced workload, 76 shipyards or repair facilities have closed during the last five years. The closings have significantly reduced the capability of the shipbuilding and repair industry to meet mobilization requirements.

Since 1982, over 52,500 production worker jobs have been lost because of shipyard closings or because of work force reductions in operating shipyards. Currently, shipyard production workers and experienced shipyard management personnel are concentrated in the largest private shipyards, which are engaged primarily in Navy new construction work. Perhaps the most startling fact uncovered by the Commission study is that the five largest private shipyards, with a total of 54,300 production workers, and the eight naval shipyards, with a total of 34,400 production workers, employ about 65 percent of the total industry work force.

The West and Gulf Coasts have been affected most by the contraction of the shipbuilding industry. My written statement contains details on the number of yards and workers lost on each coast. Mr. Chairman, in your opening remarks you made note of the situation on the West Coast.

In addition to the declining ship construction industry, shipyard suppliers and the United States industrial base as a whole have declined in a similar fashion.

The Commissioners concluded that the United States has become alarmingly dependent upon foreign sources of critical equipment, ranging from major propulsion system components to precision bearings, for Navy as well as for commercial ships. In some cases, our newest, most technologically advanced, and most important Navy weapon systems rely upon foreign manufactured components.

The Commission conducted an extensive analysis to determine if the shipbuilding industry could accomplish all its assigned mobilization tasks without jeopardizing national security. That analysis was based upon data and statements of requirements provided by the Department of Defense, the Department of the Navy, and the Maritime Administration.

When considered on a coast-by-coast basis, only the East and Gulf Coasts today have sufficient manpower to accomplish all surge phase requirements on schedule. If current trends continue on the West Coast and the Gulf Coast, the problem will only get worse and could adversely affect accomplishment of the most important task, the reactivation of the Ready Reserve Force.

Although the shipbuilding and repair industry would be able to meet the initial mobilization requirements, performance during a prolonged conflict would be constrained by shortages of shipyard facilities, manpower, and material from the supplier industries. Adequate shipbuilding positions are not now available to meet currently defined Navy or merchant marine construction requirements during a long mobilization. Given current and projected capabilities, the shipyard supplier industries could not support mobilization new construction requirements during a prolonged conflict, now or in the year 2000.

As a result of their study, the Commissioners concluded that maintaining the shipbuilding and repair segment of the industrial base required to sustain a protracted general war is essential to deterring or winning such a war. The base of shipyards and repair facilities and their industrial suppliers is currently inadequate in that sense, and is continuing to deteriorate at an alarmingly progressive rate.

Although the Nation's military strategy requires use of merchant shipping assets in time of crisis, and parts of that strategy are predicated upon the availability of ships, crews, and shipyards, wartime availabilities depend on the adequacy of the resources existing in time of peace. That is certainly and especially true for the shipbuilding industry, which would have to be in a position in time of conflict to make up any peacetime shortage of ships, both military and commercial.

Our Nation simply cannot afford to be in a position where it has neither the ships nor the industrial capacity to build them quickly and well. Nonetheless, that is the state of affairs that appears to be developing at a rapid rate. Without decisive, even heroic, action, it will surely come to pass. At the same time, however, it is important to recognize that there is no easy, cheap, or quick fix to a truly difficult problem.

It is the prospect of the deterioration of America's maritime industries and of the strategic shortfall that would result that most concerns the Commissioners and that underlies their report. It is the paramount need for action that provides the impulse and the motivation for their ongoing efforts.

Thank you, Mr. Chairman. I would be willing to undertake to answer your questions on behalf of the Commissioners.

[The prepared statement of Dr. Cameron may be found at the end of the hearing.]

Mr. **Anderson**. Thank you, Dr. Cameron.

The Commission has concluded that major governmental effort is urgently required to reverse the maritime industry's decline. What should this effort entail?

Dr. **Cameron**. Mr. Chairman, the Commissioners will address specific measures in their report of recommendations, which is due as of the end of this month and probably will be published in January. It would be presumptuous of me at this stage to prejudge what they will recommend.

Mr. **Anderson**. Couldn't you even guess?

Dr. **Cameron**. I could guess, but it would be no more than a guess.

Let me suggest though, sir, that the findings of fact and conclusions in the First Report may contain some guideposts or some indications that one could look at for some idea of the way the Commissioners' thinking may move.

Mr. **Anderson**. Would you elaborate on the conclusion that domestic waterborne trade and Government-impelled cargo cannot support a merchant marine of the size and characteristics needed to meet our national security requirements?

Dr. **Cameron**. Yes, sir. There simply is not enough cargo from those sources to support in commercial operation the number of ships that are required to meet the stated Department of Defense movement requirements. The merchant marine today is carrying exactly that cargo, plus or minus, and the merchant marine is too small.

Mr. **Anderson**. Would you cite some examples of foreign government support for their shipbuilding and their repair industries that buttress the conclusion that free trade does not exist?

Dr. **Cameron**. Yes, sir. Let me point out that that conclusion as stated in the First Report dealt with ship operators, not with the shipyard industry, but there are some things that can be said usefully.

The Commissioners have not yet conducted detailed analyses of the conditions of U.S. and foreign industries. They do know, however, that shipyards elsewhere are heavily subsidized, heavily supported, more so than in the United States, by governmental action, and are protected from economic vagaries and from many of the pressures that bear on the U.S. industry. I could give you a rundown of categories of actions, but I won't do that at this point.

Clearly, foreign yards have advantages that U.S. yards do not have. At the same time, however, it would be a mistake, I think, to assume that those advantages are the only cause of the problems faced by United States shipyards in competing in the commercial market.

[Editor's note.—Reference a June 1988 report from the Maritime Administration, "Maritime Subsidies", which can be found in the Subcommittee files.]

Mr. **Anderson**. Will you address the permanent losses that result when shipyards close or are forced to lay off workers?

Dr. **Cameron**. Yes, sir. The first thing that happens is that the workers from those shipyards go to employment in other industries, or in other trades and crafts, or relocate to other areas of the country. People want a stable income for their families, for their children, for the future, and are unwilling to risk a livelihood on the possibility that a yard might reopen or get a new contract at some undefined time in the future.

The yards themselves, as was indicated earlier in some of the questions and answers, tend to be converted to other uses, whether Toyota import facilities, or sites for condominiums, or national parks.

In the Appendices to the Commission's First Report beginning on page 111, there is a data base that goes over the shipyards that closed during the past several years. It indicates the uses to which those yards have been put. I commend that to you and your colleagues.

Let me also say that the facilities in closed yards, but even in open yards, deteriorate when they are not used for construction or for their intended purpose. We had that mentioned earlier by Admiral Horne. In our experience on the Commission, the staff was carrying in the data base a particular facility for a particular shipyard. It was a new construction facility. A vice president of that company came to visit us, looked at our data base about his yard, and said, "You are carrying that as an active shipbuilding facility, but let me tell you that it is not an active shipbuilding facility. It hasn't built a ship in 10 or a dozen years. It has deteriorated. It could not now be used without major work." So, the facilities do deteriorate and do go away and are difficult to reconstitute.

Just think of the cost of trying to build a graving dock today, particularly a graving dock of large size. And yet, we have seen graving docks go away on every coast during the last decade.

Mr. ANDERSON. Would you address the national security implications of the diminished number of shipyards and production workers on the West Coast?

Dr. CAMERON. Mr. Chairman, the real question is really overall capacity in the country as a whole. Some aspects of the shipyard problem are coast-sensitive, such as repair and maintenance, but we need to keep our eye on the total capacity. In your opening remarks, you stated the facts that the Commissioners submitted in their report about the situation on the West Coast.

In the short term, you could, if the situation continues to deteriorate, lose the capability to reactivate the portions of the Ready Reserve Force that you must be able to reactivate in the West Coast and whose reactivation is time-sensitive. You may also lose the capability to reactivate the National Defense Reserve Fleet if you wish to reactivate that. Moreover, you may lose the capability for battle damage repair, which is clearly coast-sensitive in terms of where it has to be done.

Shipbuilding may or may not be coast-sensitive in time of conflict. The instinct says that it is. I am not convinced that the facts would bear that out, although I think they probably would.

The key point, I think, Mr. Chairman, is not so much how we cut the pie but the fact that the pie is too small altogether. It is, in fact, the collapse of commercial ship construction that the Commissioners believe has been the major cause of the shipyard problem.

Mr. ANDERSON. Mrs. Bentley?

Mrs. BENTLEY. Thank you, Mr. Chairman.

Dr. Cameron, I want to commend the Commission for an excellent report. I have read it from front cover to back cover. It couldn't have been put together better. And I was so glad when I saw the stress on the industrial base and the effects that that is having on our maritime industry.

We recently had a battle on the floor about cargo preference. And those of us who were supporting it, the Chairman, Mr. Lowry, and myself, were disturbed about the fact that the agriculture industry which is getting $26 billion was fighting the maritime industry for a minuscule amount by comparison, $327 million. That wasn't the real battle, and it was about cash transfers. But those are the comparisons.

Is cargo preference one of the last legs that the maritime industry has to stand on to keep what ships are going in operation now?

Dr. CAMERON. Clearly, cargo preference is essential to many of the ships that now operate. Certainly, that is the case in the Jones Act trade. Certainly, according to what we are told by the ship operators, that is the case with much of the international trade; not all of it but much of it. The liners tend to be a little more competitive. But, for example, for the small U.S.-flag bulk fleet, particularly the dry bulkers, it is cargo preference trade.

Mrs. BENTLEY. But cargo preference is very important, and even though it is not all that great, it is still very vital.

Will you support any kind of—do you think that any kind of a program such as UNCTAD has been playing around with, like 40-40-20, the 40 percent of cargo carriage being between the two trading partners and the 20 percent being the third flag—do you think that anything like that should be developed in this country by this Congress?

Dr. CAMERON. It would again, Mrs. Bentley, be presumptuous for me to prejudge the Commissioners. Certainly, the argument has been made to the Commissioners that cargo preference in some form, including the UNCTAD agreement, is something that should be seriously considered. Other people who have appeared before the Commission, both in public and in private, have argued exactly the opposite.

The Commissioners clearly consider it to be a serious proposal, but also one that requires extremely careful study and analysis so that you know what happens if you do something like that.

Mrs. BENTLEY. The one section that you have in here I think sort of summarizes the importance of cargo preference and whatever else we can do for American industry because at least there is some reason to have one or two of the suppliers available in this country. But if everything goes offshore, we are not going to have any kind of supply left in this country from what I gather from what the Commission is saying. And then we are really going to be in critical trouble. I mean, we are in serious trouble now, but we could be in very critical trouble.

Dr. CAMERON. Absolutely, and particularly in time of conflict. If you do not have the domestic capability to manufacture, for example, main propulsion systems, slow speed diesels, it makes no difference whether you can build the ships on the ways if you don't have the power plants to put in them. If you don't have the capability to make quiet ball bearings, then it doesn't matter whether you have the shipyard capability to build nuclear submarines.

One has to look not only at the most obvious parts of the problem, but also the sub-tiers. And both the shipyard people and the supplier industry people who appeared before the Commission in open session were really strikingly outspoken on the matter and got a lot of attention from the Commission.

Mrs. BENTLEY. Yes. Well, I am anxious to read all of the testimony. Is that available to those of us who want it?

Dr. CAMERON. Yes, ma'am. I think two copies were sent to your office two weeks ago probably.

Mrs. BENTLEY. Well, I haven't seen it. Okay. I'll make a point to look for it.

Thank you, Mr. Chairman.

Mr. ANDERSON. Mr. Lowry, you have five minutes.

Mr. LOWRY. Well, thank you, Dr. Cameron, for your excellent work. And I want to thank the Chairman again for having you here at this time before the recommendations come out because we thought it was so important. It was really at my request that we pushed up the hearing date to get the amount of work you have been doing up to now and I realize that the recommendations are still to come.

In your report there was an emphasis on the problem of Government procurement policies emphasizing the bid price rather than the value and that the effect of that upon our shipbuilding and repair industry capability. Could you emphasize that just a little bit more?

Dr. CAMERON. There are really two aspects to it that the Commissioners had in mind. One of them dealt with ship operators, and has to do with the procedures by which the Navy procures ocean transportation services from commercial operators. There is a sense there that the bid policies being followed encourage buy-ins, encourage bids from almost ephemeral carriers that exist only after they are awarded a contract, and that the effect has been to drive many of the major companies out of some of the trades because they simply could not survive at those rates.

There is disagreement within the various communities about the degree to which that's a fact. The ship operators make one argument and the people who do the buying make other arguments. The Commissioners have listened to both, although I think that their report indicates that their sympathies are rather more on the side of the ship operators because they believe the facts support that position.

On the shipyards, this has been an area that has been difficult for the Commissioners to address because, although clearly Navy procurement policies are important to the shipbuilding base, the Commission does not have a specific mandate to look at Navy procurement policies. The Commissioners have said, "Look, we are not in the business of second-guessing the Department of Defense on things that are not clearly within our charter." But the shipyard people who came before the Commission in public session raised the issue across the board as a problem. The matter was discussed in private testimony with Navy officials, many of whom indicated that, yes, there is a problem.

I think that the Commissioners are of the view that, in a rational world, you need to balance cost or price against quality, and against performance, and against the requirements of the industrial base. To emphasize any one of those criteria at the expense of the others hurts you in the long run. When you emphasize low cost, you have short-term savings, but you undermine the long-term existence of the resource.

Mr. LOWRY. Thank you very much, Dr. Cameron, for a very precise and quick answer to a tough question.

Thank you, Mr. Chairman.

Mr. ANDERSON. Thank you, Dr. Cameron, for your presentation.

We will stand in recess for about 15 minutes and when we return, we will take up our next panel.

Dr. CAMERON. Thank you, Mr. Chairman.

Mr. ANDERSON. We stand in recess.

[Recess.]

Mr. ANDERSON. The meeting of the Subcommittee will come to order.

Our next witnesses are our industry panel: Hans Schaefer, Chairman of the Board, Shipbuilders Council of America and President, Todd Pacific Shipyards Corporation, Seattle, Washington; John J. Stocker, President, Shipbuilders Council of America; and Marcia W. Kinter, Manager, Shipyard Operations, American Waterways Operators, Incorporated.

We have all of your prepared statements. They will appear in the record.

I'm not going to tell you how to start, whether you want to start the way it is here with Mr. Schaefer, Mr. Stocker, and Ms. Kinter, or any way you want. It's up to you.

STATEMENT OF HANS K. SCHAEFER, CHAIRMAN OF THE BOARD, SHIPBUILDERS COUNCIL OF AMERICA AND PRESIDENT, TODD PACIFIC SHIPYARDS CORP., SEATTLE, WA

Mr. SCHAEFER. Mr. Chairman, if it is all right with you, why don't I begin?

Mr. ANDERSON. Why don't we call on Mr. Schaefer? [Laughter.]

Mr. SCHAEFER. OK.

Mr. Chairman and Members of the House Merchant Marine Subcommittee, everybody knows who I am through the introduction so I will not repeat all of that.

My comments here today address the worsening condition of America's shipbuilding and ship repair industrial base. The first report of the Commission on Merchant Marine and Defense, as we have heard before, has set the stage for today's hearing and, hopefully, for a new Federal program and/or policies that can reverse the deteriorating of our industry.

To summarize again, the key findings of the Commission's First Report tell us that, one, the shipbuilding and repair industry and its associated suppliers are, and will continue to be, an essential defense mobilization resource; and two, to survive and provide the capabilities required to respond to mobilization demands in peacetime, the industry must have a sufficient workload providing a reasonably profitable level of operation.

The Commissioners further agreed that current Federal programs have provided only enough support to slow, not halt or reverse, the advancing decline of this vital industry, and that a major governmental effort is required—indeed, overdue—to reverse the erosion of a strategically dispersed shipyard base.

One conclusion from the Commission's report has particular relevance to my company's current condition: "The Commission notes the recent trend in the shipbuilding and repair industry toward closing or filing for bankruptcy under Chapter 11 by a number of major core shipyards. Several other major core shipyards will follow suit."

The Commission notes further that, "The demise of a major core shipyard involves not only the loss of critical facilities and perhaps several thousand employees, but also the loss of an infrastructure of equipment, knowledgeable management, and skilled production workers that would be central to any shipyard expansion required during a mobilization."

Four months ago Todd Shipyards, once the Nation's largest independent shipbuilder, joined the growing number of domestic shipbuilding and repair companies, especially on the West Coast and the Gulf Coast, that have been forced to seek protection under Chapter 11.

Since 1982, the number of skilled shipyard production workers on the West Coast alone has fallen by more than 50 percent. Todd's Seattle and Los Angeles divisions are the only remaining yards on the West Coast with current experience in building naval surface combatants. Those two divisions have delivered 30 guided missile frigates since the mid-1970's, with the final vessel of this class now under construction in Los Angeles. Employment at Seattle and Los Angeles exceeded 8,500 during the height of the building program. Today, combined employment barely exceeds 2,000.

The Commission confirms the representative nature of Todd's employment decline when it concludes that "shipyard manpower, both managerial and production workers, has been reduced to critically low levels, especially on the West and Gulf Coasts."

Those conclusions are precise and irrefutable. The crisis in the shipbuilding and repair industry has now been independently confirmed. Shortly, the Commission will publish preliminary policy recommendations.

I urge you to continue your leadership role by taking timely action on the forthcoming maritime policy proposals.

This Committee has already taken several positive steps that help support the shipyard base. The fishery anti-reflagging legislation is a prime example. True Americanization of the Pacific Northwest fishery will help create new commercial markets for American shipbuilders and repairers in the area.

I commend the Committee for its efforts to preserve and revitalize the Title XI Ship Financing Guarantee Program. Another worthwhile effort is continuation of the joint industry-Government shipbuilding research and development program. I specifically congratulate the Subcommittee for its apparently successful opposition to the preliminary maritime-restrictive provisions of the recently-negotiated trade agreement with Canada. This Subcommittee deserves praise for raising objections to what threatened to be an ill-conceived and damaging attack on Congress' lawmaking authority.

Finally, Mr. Chairman, I urge you to encourage the Navy to place even greater emphasis on industrial base preservation in shipbuilding and repair contracting decisions. One Navy policy which does promise help to preserve a dispersed ship repair and supply base is the Navy's Strategic Home Porting Program. Under this program, two of Todd's three shipyards will realize expanded repair bidding opportunities.

In closing, Mr. Chairman, let me again express my thanks for the invitation to testify today. We are at a critical turning point for America's maritime industry. Now is the time for action.

I will be happy to answer any questions, Mr. Chairman.

Mr. ANDERSON. We're going to hold the questions until all three of you have made your presentations.

John Stocker, are you next?

STATEMENT OF JOHN J. STOCKER, PRESIDENT, SHIPBUILDERS COUNCIL OF AMERICA, WASHINGTON, DC

Mr. STOCKER. Yes, Mr. Chairman.

Thank you very much for extending an invitation to the members of the Shipbuilders Council to testify in front of this Subcommittee this afternoon. I am John J. Stocker, President of the Shipbuilders Council of America, which is the national trade association representing America's shipbuilders, ship repairers, and manufacturers of marine equipment. Presently, we represent well over 94 percent of the total shipbuilding and ship repair workers in the United States of America.

This subcommittee this afternoon has heard numerous statements about the present physical condition of the industry in terms of the number of facilities that are presently open and the number of workers that are currently employed in those facilities. I might note that, back in October of 1982, the Navy did a study that was known as SYMBA at that time, the Shipyard Mobilization Base Analysis, where they found that there were 110 private shipyards in the United States that they needed to count on for mobilization purposes, employing roughly 112,000 production workers. Today, that same base has declined to 74 shipyards employing 85,000 production workers. At that time, Members of the Subcommittee, I should point out that it was considered that 112,000 production workers was the minimum necessary to maintain the base for mobilization purposes. If that was the case then, we are already 27,000 production workers below the minimum level.

I might note that, while the Commission on Merchant Marine and Defense looked at a different base than the one that was analyzed by the Navy back in 1982, it has come up with a series of numbers that indicate that the situation has certainly not improved, even with looking at differing methodologies and differing definitions of what the base should look like.

This subcommittee will not be surprised to hear that the shipbuilding business is an expensive proposition, given the nature of its economics. The shipyard requires an operating plant, waterfront property, and in these days of increasing technological complexity, a highly-trained work force. If a shipyard closes, the physical space and prime waterfront property are irreplaceable, given the magnitude of dollars that can be made in real estate development.

A highly-trained work force is even more valuable and also irreplaceable, not only if a yard closes but when layoffs occur as well. As the work load declines at a particular shipyard, layoffs are the general rule. These workers are frequently forced to seek work in other occupations that can provide them with much more stable employment. In one case, a shipyard was successful in winning a Navy contract that required recall of 1,200 workers from layoff status. This shipyard was successful in attracting only 100 workers back to work.

Now, I might point out that this is an incredible anomaly. We have an industry that is in an excess capacity situation. When you look at the macro numbers, when you look at the individual situation in a number of shipyards, we have yards that are having difficulty in attracting and maintaining skilled talent. This is a situation and a problem that is going to become exacerbated in the future.

Not only do we express some concerns about the status of the industry as a whole, we have engaged in dialogue and conversation not only with the members and staff of this subcommittee but other committees as well and with the Commission on Merchant Marine and Defense on some potential solutions. If I might, I would like to highlight some of the areas of concern that we have.

One, we are very much interested in creating a fair trade environment for U.S. shipbuilders. This Subcommittee will not be surprised to learn that we are essentially an industry that is forced into an international arena where we are not subsidized and the other fellow is. We cannot compete in that kind of a situation on a price basis, so we would ask for Congress to urge the Office of the Special Trade Representative to look at what foreign governments do in terms of subsidizing their own shipyards.

In addition, we believe that the time is ripe to develop some programs that would lead to construction of new ships. I might point out, as has been pointed out earlier, that on November 9th of this year the last merchant ship under construction in the United States was delivered to its owner. There are no new commercial oceangoing ships under contract or under construction anywhere in the United States of America. That is the first time in our Nation's history that we have ever had that situation. Even in 1932 at the height of the Depression, we had a number of vessels under construction. There were no new orders in that particular year, but there were 20 ships under construction at that time, and from 1932 on until the start of World War II the number of new orders increased every year.

We would urge this Subcommittee, in the development of a commercial shipbuilding program, to support language that is resident both within the Department of Defense Authorization bill for fiscal year 1988 and is in the Senate's version of the Department of Defense Appropriations bill for fiscal year 1988 to support "build and charter" for sealift tankers.

We would also support language from this Subcommittee that ships purchased for the Ready Reserve Force would be given a preference if those ships were U.S.-built and U.S.-flag tankers. We would be pleased to discuss with this Subcommittee the development of a "build and charter" program for clean product tankers for the foreign trade because we perceive that there are economic conditions in the foreign trade that would lead to potential new ships to be constructed as well as to meet sealift requirements for the Department of Defense.

Also, we would like this Subcommittee to support our efforts to develop the export market in Foreign Military Sales. This industry has an enormous expertise in the building of warships, probably the finest in the world, and this is a market area that we have never seriously considered in the past. The Council is attempting to take steps right now to develop the capability and potential in this market.

We would ask the Subcommittee to preserve the integrity of the Jones Act. Mr. Schaefer already pointed out to you our concern that existed with the United States/Canada Free Trade Agreement, and we were pleased to note that the maritime provisions in the Free Trade Agreement were dropped. For that, we thank this Subcommittee for its efforts, as well as the Congress in general.

Finally, we would have the Subcommittee continue its support for certain maritime programs, such as title XI, the Ship Mortgage Guarantee Program. We believe there are some orders for ships out there that potentially, with the support of a Government guarantee program, could be constructed in U.S. shipyards.

Without these kinds of efforts, members of the subcommittee, we can witness further decline in this industry. It cannot continue. We are facing a situation where we are no longer able to meet our national security requirements. We are seeing an industry that is now hemorrhaging. We look to this Subcommittee for development of support to reverse the trends that I have outlined.

Thank you very much, and I will attempt to answer any questions that you may have.

[The prepared statement of Mr. Stocker may be found at the end of the hearing.]

Mr. ANDERSON. We will hold the questions.

Ms. Kinter?

STATEMENT OF MARCIA Y. KINTER, MANAGER, SHIPYARD OPERATIONS, AMERICAN WATERWAYS OPERATORS, INC., ON BEHALF OF D.F. SMITH, CHAIRMAN, AMERICAN WATERWAYS SHIPYARD CONFERENCE

Ms. KINTER. Thank you. Good afternoon, Mr. Chairman and Members of the Subcommittee. My name is Marcia Y. Kinter, and I am Manager of Shipyard Operations for American Waterways Operators. I am here today in place of Mr. D.F. Smith, Chairman of the American Waterways Shipyard Conference, or AWSC. Regrettably, Mr. Smith could not be with us today.

AWSC represents the interests of the small- and medium-sized commercial shipyards which build and repair the vessels for the barge and towing, fishing, and offshore service industries. These same shipyard facilities also build and repair the smaller vessels for all branches of our Armed Forces. AWSC is a conference of the American Waterways Operators, the national association for the barge and towing industry.

We appreciate the opportunity to appear today to discuss with you the decline of the shipbuilding and repair industry. Smaller shipyards, similar to our larger counterparts, have hit upon hard times. I do not wish to dwell upon the industry's current state; those present are fully aware of the shape of the industry. But for the record, since 1981, new construction activity for the smaller shipyard facilities we represent has declined by 85 percent. We have seen employment levels decline by 80 percent, and 106 facilities—or 36 percent of the smaller shipbuilding facilities—have ceased operations.

Today, I would like to address areas where the members of the American Waterways Shipyard Conference feel that you, as Members of Congress, can be instrumental in helping the industry achieve a sense of stability once more. A strong shipbuilding industry profits this country in terms of both economics and national defense. The smaller shipyards have, and continue to, contribute to the shipyard mobilization base deemed necessary for our defense purposes.

Economically, we provide work not only for those employed directly in our shipbuilding facilities but also those employed in the related maritime supply sector. Although we appear small, we do exert a tremendous impact on our Nation.

The small shipyard industry, in terms of economics, actively contributes by building and repairing the vessels utilized in the many diverse domestic trades. We are a protected industry, protected by the Jones Act and related cabotage laws which restrict domestic transportation to U.S.-built, -owned, and -crewed vessels.

Modernization of the Jones Act, long supported by this Association, would afford new commercial market opportunities and provide stabilization to the industry.

We commend you, Mr. Chairman, Mr. Biaggi, and Members of the Subcommittee and Full Committee for your willingness to address the need to modernize U.S. cabotage laws to reflect evolving economic and technological activities. This attitude is clearly reflected in the recent legislative activity surrounding H.R. 82, which would apply our coastwise laws to the transportation of valueless materials to an unfixed point within the Exclusive Economic Zone. The application of the Jones Act to all activities within the EEZ will provide new commercial opportunities for U.S. shipyards.

We also applaud and commend the Members of this Subcommittee and the Full Committee, as well as the Subcommittees on Coast Guard and Navigation and Fisheries and Wildlife Conservation and the Environment, for their help concerning the prohibition of foreign conversions of U.S.-built vessels for our domestic fishing industries, an issue which is so critical to our industry.

It is hoped that with the now-favorable developments concerning the Transportation Annex of the United States-Canada Free Trade Agreement that these issues will be resolved favorably before Congress adjourns.

Without new commercial opportunities, the shipbuilding industry will further decline, leading to a further reduction in the shipbuilding mobilization base necessary for our national defense. Government contracts cannot and should not be the industry's main source of revenue. If that is to be the practice, we are sure to lose even more shipbuilding facilities.

The Commission on Merchant Marine and Defense has publicly stated that the combined maritime industries are essential to our national defense and, in the long run, to the economic well-being of our country. It behooves us now to plan for the continued existence of the shipbuilding industry, and it will require Government and industry involvement. The most efficient way is to maintain an active merchant marine of U.S.-built vessels engaged in foreign commerce, manned by U.S. crews. An active fleet would provide work for the shipbuilding industry, ensure a viable shipyard labor pool, and maintain experienced mariners.

Thank you, and I'd be happy to answer any questions you might have.

[The prepared statement of Mr. Smith may be found at the end of the hearing.]

Mr. ANDERSON. Thank you.

I have some questions here. Some will be to you individually; others will be to all of you.

I think I will direct the first one to Mr. Schaefer. Would you expand on your statement that Americanizing the Pacific Northwest fishery will help create new commercial markets for American shipbuilders and repairers?

Mr. SCHAEFER. We understand, Mr. Chairman, that the North Pacific fishing industry is currently short in the neighborhood of 70 vessels—that is, factory vessels and fairly large bottomfish-type vessels. It is felt in our industry, and especially by those of us who come from Seattle, that a reflagging effort of foreign bottoms is not in the best interest of our economy and certainly not in the interest of our particular area. We, therefore, feel that the Americanization of those vessels, or the building of new vessels or the conversion of existing vessels, would certainly help the economic plight of our particular area.

Mr. ANDERSON. Mr. Schaefer, would you also comment on why the Gulf Coast and West Coast have been particularly hard hit by the shipbuilding recession?

Mr. SCHAEFER. Mr. Chairman, until recently—and this is partly true up to the present—the wages on the West Coast were generally larger than on the Gulf and on the East Coast. That was particularly the case when the now-declining Navy contracts became available for bid. Since we could not participate—the West Coast, that is—in those particular bids on an economic basis, I believe we lost several lucrative opportunities and therefore had to take our toll in reduced employment. That is changing. That has changed, but so have the opportunities to date.

Mr. ANDERSON. I understood there was a differential where the West Coast was higher than the Gulf area, but I didn't think it was that much higher than the East Coast, the New York area. I thought their labor scale was about the same as the West Coast.

Mr. SCHAEFER. Currently, it is with respect to the Seattle area. I believe that the Los Angeles area still is at a disadvantage and is working on remedial action in that regard.

Mr. ANDERSON. In other words, the Los Angeles area is higher than both Seattle and New York?

Mr. SCHAEFER. Yes, sir. It's higher than Seattle at this point in time.

Mr. ANDERSON. My next question is for any one of the three of you. Is research and development so critical to our mobilization base that we need to fund it even in tight budgetary times?

Mr. STOCKER. Mr. Anderson, if I might, I will address that question.

One of the major problem areas for the U.S. shipbuilding industry is that there has been a continuing effort over the past several years to finance both Department of the Navy and Maritime Administration research in improving industrial processes within the industry. It is an area that we would like to see considerable attention paid to, particularly in the future. We think reductions in terms of construction manhours can be achieved. To cut off funding at this time would make it virtually impossible for us, if at some future time we were able to compete on a manhour basis, to compete with foreign shipyards.

Certainly, it's true that the payoff from R&D investment, now in tight budgetary climates, is going to generate a payoff downstream even in terms of defense programs. If we can reduce manhours in the production of naval vessels, we can reduce the cost of those as well and have a salutary impact on the defense budget.

Mr. ANDERSON. This one is for any one of you. Would you comment on the permanent loss of highly-trained workers that may result from shipyard closings and layoffs and operating shipyards?

Mr. STOCKER. As I mentioned in my oral comments, one of the really strange anomalies that we're beginning to see in this current situation is the fact that we have shipyards laying people off and shutting down facilities, and yet some shipyards that have been the beneficiaries of some Navy contracts are, in fact, having a difficult time hiring and retaining skilled and talented people. I can tell you that in some locations—for example, in the Northeast where unemployment rates are very low anyway—the ability of those shipyards to go out and acquire and retain skilled talent is very, very difficult. We're a little concerned about the downstream impact of that. What we see as a potential regional problem is going to develop into a national problem because anybody who has a skill and who can market himself to another industry will go to that industry when faced in his present employment with uncertain workloads in the future.

Mr. ANDERSON. John, I think my next question is to you. You have called on the Government to study the shipbuilding and repair capability needed for our Nation's commercial and military needs. Are you satisfied with the findings of the Commission on Merchant Marine and Defense on this subject?

Mr. STOCKER. Yes, Mr. Chairman, we are. We think the report of the Commission is absolutely first-rate. It is an objective body, not embodied within any particular agency, and, therefore, it is not saddled with any of the bureaucratic impediments that we see in some of the present agencies. As a result, within the purview and the charter of that organization, they have been able to do a really first-rate analysis. We're very pleased with the fact that they have found a situation in our industry that we have been attempting to describe to people at large for some time now.

Mr. ANDERSON. John, what are some examples of subsidies that foreign governments provide?

Mr. STOCKER. Yes, sir. I can point out a couple of different examples. In the case of American President Lines' recent acquisition of five container ships in West Germany, the West German Federal Government stepped in with direct cash payments to two shipyards in West Germany that totalled roughly 55 percent of the cost of those five vessels. Those funds were provided directly from the Bundestag to the resident shipyards and were applied directly to their working capital as well as to investment in capital plant, which is, of course, going to make it possible for those two shipyards to compete in the future because they have newer capital plant in their facilities.

We have also seen examples of the Canadian Government stepping in and making similar kinds of investments, direct investments out of the public treasury, in their shipyards. A recent award to a Vancouver shipyard of a new icebreaker contract constituted several million dollars' worth of direct payments from the Canadian treasury to that yard's working capital fund and capital plant improvement program as well.

We have examples involving South Korea where the Central Bank in South Korea steps in frequently to offer below-market rate financing. That is something that we absolutely cannot compete with. We have no facility within the United States to attempt to obtain below-market rate financing. Frankly, that—at least in my conversations with several of our shipyard CEO's—is one of the primary problems in competing internationally. We cannot get below-market rate financing.

Mr. ANDERSON. My next two questions are for anyone.

I understand that many unskilled laborers built and repaired ships during World War II. Will you address the length of time it would take to train shipbuilding and repair workers should a war or national emergency develop today?

Mr. SCHAEFER. Mr. Chairman, the record is clear that training is required for brand new people coming into the industrial base. Recent history has shown, that when our company, for instance, elected to change from commercial work—that is, conversion and repair work, and some modest new construction work—into naval work, it cost the company and the Government between $20,000 and $25,000 per person to change and train an individual from commercial shipbuilding skills to naval shipbuilding skills.

I would assume that, if a mobilization were necessary which required unskilled workers to be brought to idle shipyards, as it were, that the number in terms of dollars would probably be approaching that amount.

Mr. ANDERSON. My next question is for anyone. Why did the Navy prohibit construction of diesel electric submarines for foreign sale?

Mr. STOCKER. I've been volunteered to answer this question, Mr. Anderson.

Mr. ANDERSON. Well, it came out of your remarks.

Mr. STOCKER. Let me be blunt. There are bureaucratic forces resident within the Executive Branch that were concerned about the construction of diesel electric submarines in the United States and the possible impact on nuclear submarine programs. Of course, this is a tremendous fallacy on the part of those bureaucratic elements because of the fact that the Navy has done a fine job in articulating the need and demand for nuclear submarines to fulfill both the strategic and attack missions that they have outlined for those submarines.

However, this industry, because of bureaucratic intransigence, lost potential orders of upwards of 30 diesel electric submarines to foreign shipyards.

Mr. **Anderson**. This is for any one of you. Will you give us some examples of the type of industrial activity that is conducted in former shipyards?

Ms. **Kinter**. I know that of the smaller facilities that have closed, one up in Minnesota has turned into a brick-fabrication facility——

Mr. **Anderson**. A what?

Ms. **Kinter**. A brick-fabrication facility. I know of shipyards that have been closed and industrial activities are not going on; it is more for condominium development.

There is a facility which closed in Pittsburgh; part of it has been reopened as a shipbuilding facility but on a smaller scale, and the other portion of the facility is being operated for Caterpillar trucks.

The majority of the yards that have closed are not reopened for any type of industrial activity. They are either idled or closed for their land for use in other areas. They are not able to be recouped for future shipbuilding.

Mr. **Anderson**. Marcia, would you expand on your discussion of how enactment of H.R. 2598 would benefit your industry? Could you comment on that?

Ms. **Kinter**. I don't know if it would be correct to say it would expand the industry as much as it would expand the current commercial market opportunities that we have. There are numerous U.S.-built vessels that are going to foreign shipyards for conversion into factory trawlers, and catcher processors, to be used in the domestic fishing industry. These activities can be done in U.S. shipyards. We can compete with the foreign yards. We cannot compete with the foreign subsidies that are being offered to induce the operators to go over to the foreign yards to have these conversions undertaken. It would be an expansion of the market more than the creation of a market. We do the conversion work now, but the bulk of it is done overseas.

Mr. **Anderson**. Marcia, you state that, while you prefer to buy American maritime supplies, that you increasingly look to foreign suppliers. Is this because the supplies are not available in the United States?

Ms. **Kinter**. Yes. I get increasing information that U.S. steel is not available in the United States for purposes of repairing and constructing vessels, that pressure tanks which are used to build pressure barges, are not available in the U.S. or if they are, they are at highly inflated costs. It's not feasible to use them on a U.S.-built vessel; it is preferable to go overseas and purchase them. This is not something that they like to do, but in order to remain competitive with all the other shipyards they are forced to look to foreign sources for some of their materials.

Mr. **Anderson**. My last question is, I think, to any one of you. Maybe I'd like to hear from all three of you on this one.

Would you list some of the things that you have done to increase your productivity?

Ms. **Kinter**. It's difficult—the smaller shipyards are at a disadvantage in that we are losing our capability to produce vessels rapidly. Of all the major yards that have closed, it is those yards that have the capability to what we call "serially produce" vessels, where we can produce up to one or two tank barges a week in addition to 30 hopper barges and a couple of tugboats.

I know that, within the smaller facilities which are still viable, they consider adaptation of computer services in that realm as increasing their productivity.

A lot of the smaller facilities do try to utilize quality circles within their workplace; but, because of the size of the work force, 40 or 50, it's difficult to do. There's a lot of cross-utilization. Also, a majority of the smaller yards are non-union, which also is a lot easier to work with.

Mr. SCHAEFER. My company over the last 10 years has invested roughly $200 million in new systems and equipment, such as floating drydocks of a modern nature and synchro-lift in Los Angeles, and over a prolonged period has engaged the services of a Japanese contractor to work with our shipyards to develop certain labor cost-reducing initiatives. They have produced a better climate for our products to be brought to market; but, nonetheless, they require volume, and volume is one thing we no longer have at this stage. To employ certain imported production enhancement projects or plans is only good when you have more than one item to build, whether that be a barge or a vessel of any kind or even a building.

So, as we have spent this kind of money over the past 10 years, it is now felt that that investment to a large extent cannot be fully utilized as we go on into the future.

Mr. ANDERSON. I visited your plant once, and you had a "robot" that was "the answer" at that time. This was several years ago, and you were showing how great it was going to be in doing the work of many people, and so on. What happened to that? Because I haven't heard anything about that lately.

Mr. SCHAEFER. The robot is still used on the last Navy ship in Los Angeles, which we complete under the F57 program. It is being used for welding purposes and partly for the application of toxic paints and so on, to reduce workmen's compensation costs in case they come into play. But with the last ship under construction, there goes the use of the robot.

Mr. ANDERSON. I see.

Mr. Bateman?

Mr. BATEMAN. Thank you, Mr. Chairman.

I'd like to thank our panel, and I have one question I'd like to address to Mr. Stocker.

You were here earlier when I was inquiring of Mr. Thurman on the subject of the analysis of the 22 contracts, and 19 of the 22 were overruns in cost. I think I have him on the record as saying that this is not excesses of ceiling prices but of target prices.

Could you put that situation in context for me?

Mr. STOCKER. Yes, Mr. Bateman, I'd be glad to. In fact, Mr. Thurman was a little bit guilty of a loose definitional problem in that, in explaining what the results of their analysis contained, they failed to point out that a fixed price/incentive fee contract is structured in such a way that there is, in fact, a target-to-ceiling relationship. Above target, the Government and the contractor share in any costs that exceed target up to the ceiling point, at which point the contractor takes on full responsibility for paying for those additional costs.

There is nothing illegal, immoral, or fattening about the fact that a particular contract exceeds the target price. I would point out to the Members of this Subcommittee who heard Mr. Thurman's testimony that the shipyards in the United States have returned over $6 billion in appropriated funds to the U.S. Treasury. We are talking about additional costs on the order of perhaps $700 million, which isn't even 12 percent of the total amount returned to the Treasury.

This is not to say that Mr. Thurman is wrong. We have been pointing out to as many people as would listen that we are very concerned about some of the contracts that are out in place. Mr. Anderson asked a question about productivity investments. You cannot invest when the environment creates a situation where the Defense Department is squeezing contractors on cash flow and where there is insufficient profit to be made on such contracts.

We have a situation here where, because of the competitive process and because of the almost maniacal love of low price that has been pursued by the Navy Department over the past four or five years, we are beginning to see some potential impacts. This is not a disaster; the contracts were specifically structured to deal with target-to-ceiling relationships. In fact, in Mr. Thurman's statement, he points out that in the contracts that they studied the growth above target amounted to 16 percent. This is not even fully along the line to the 30 percent usual relationship that exists between target and ceiling. Target is a hoped-for goal if all things fall into place properly. If they don't, you have a ceiling price that protects the Government's ultimate risk so that appropriated funds are not squandered because of mismanagement on the part of the contractor or the Government.

It's a sensible program. We are just simply concerned about some of the prices that have been agreed to on these contracts because of competitive pressures, and we're concerned about the ability of yards to remain financially viable. That's why we are opposed to reduction in progress payments. We are opposed to slow release of retained funds. We are opposed in general to anything that says "let's review profitability" because if we continue at it hard enough, ladies and gentlemen, we'll drive a few more shipyards out of business.

Mr. Bateman. Thank you, Mr. Chairman.

Thank you, Mr. Stocker.

Mr. Anderson. Mr. Lowry?

Mr. Lowry. Thank you, Mr. Chairman. I just want to thank the panel also. I think their testimony shows how our shipyards are going out of business. There is an obvious question: with the 600-ship effort, the largest increase in the Navy during peacetime, how did we get into this situation? I also think there are probably some answers to that question, but let me start with you on that, Mr. Stocker. I mean, we are coming toward the tail end of the largest buildup in peacetime history.

Mr. Stocker. You're absolutely right, Mr. Lowry. And let me digress into economic theory for a moment.

You know, we've all been taught as youngsters that monopolies are bad. Monopolies are a relationship where you have one supplier and many consumers. Well, we've got a wonderful situation right now where the shipyards are multiple suppliers and we only have one consumer, and that consumer is the U.S. Navy. Over 90 percent of our workload is based in U.S. Navy programs, and the Navy has done a very good job of justifying the rebuilding of the fleet to 600 ships. We have benefitted. Without it, this industry would be in far more difficulty than it is today.

The problem is we had nothing else to support overhead. We had no commercial program. We've seen a total shipyard order book of about 13 ships over the past five or six years; none since 1984. How do you sustain a broad-based, geographically-dispersed and diversified industry on 13 commercial ships and a few naval contracts to build and develop very sophisticated and technologically complex naval ships? It's really a serious problem, and it relates to a market structure that has now become dominated by a single customer. We're in a very unfortunate situation.

Mr. LOWRY. For any of you on the panel, on the question that we've been continually asking earlier in the day, is there too much emphasis being placed by the Navy simply on the price of the bid? Should the Navy put a stronger weight onto the other factors in the bid-making decision? Are they putting too much weight on the single factor of the price? Mr. Schaefer?

Mr. SCHAEFER. We believe, Mr. Lowry, that the Navy does. They have only done this, we can assure you, during the last four or five years. Prior to that period, there was a dual evaluation process that was very open and accessible and clearly stated that technical expertise had to follow price, and it was evaluated virtually on the same basis.

There has been a vacillation on that policy lately, on two or three of the latest evaluations, but it is too late. The damage, as it were, has already been done in that too many contracts during the years of high-volume awards had been awarded to shipyards at a low price, and the results are now beginning to surface, as we heard from our friend from the GAO here. And the results are not totally known to this day.

Mr. LOWRY. That's pretty scary.

In our development of H.R. 2598 which, as you know, has passed the House—we are in continued negotiations with the Senate; we have hopes of seeing that sitting on the President's desk before we get out of here. We've been working on that for a month now, but anyway, we got it out of here—but in the development of H.R. 2598 and in the inclusion of ship conversion within that, I continually ran into examples of the below-market rate financing for conversion done in foreign shipyards relative to the ship processing.

How would you suggest that we compete against that? Is the Ex-Im Bank moving in that direction? Is that trying to work with title XI? Ms. Kinter, I think I would ask you that question.

Ms. KINTER. We never really gave it any thought as to how Government could help us in that way because for us it was an infeasible alternative, to ask for Government support to the same extent that, say, the Government of Norway was giving. It was very obvious when you went to the Fish Expo that was held in Seattle at the end of October, and the Bank of Norway was the only financial institution that was basically begging people to convert overseas. This is what we are up against, and we knew it was not a feasible alternative to approach Congress and the Government for a subsidy program similar to that.

Mr. LOWRY. Well, why not? I mean, if we're going to be talking about below market-financing and not being able to get the business, and that it is being subsidized in that case by the Norwegian government, if you're not going to go to the American government, where are you going to go?

Ms. KINTER. Would you be amenable to offering subsidy programs similar to that?

Mr. LOWRY. Well, do you think the Export-Import Bank is relative, for instance, to the Airbus financing by the treasuries of France, Germany, England, and Spain on giving subsidized financing for Airbus? Or any of the other things that the Export-Import Bank does? In other words, I think the industry ought to be sitting here saying, hey, this is the type of thing that would work for us.

Now, if you want me to develop that program, I guess we can do that too, but I would hope the industry would do something about it rather than just coming to us and saying, hey, Norway's doing this. I mean, do you have suggestions on that?

Mr. SCHAEFER. I have no suggestions for the record at this stage, but we will certainly get back to you and to the Committee with some ideas along those lines. They require somewhat more research.

[EDITOR'S NOTE.—Information on the types of financial assistance the top ten shipbuilding nations of the free world offer can be found at the end of the hearing, entitled "Low-Interest, Long-Term Financing Enhances Shipyard Competitiveness."]

Mr. STOCKER. Mr. Lowry, let me jump in at this point, because we at the Council have been giving an awful lot of thought to development of the export market over the past few months. In fact, we are—I hope I'm not being too premature—we are considering preparing an application to set up an export trading company for the purpose of attempting to sell offshore military vessels. We'll have to work in close cooperation with both the Departments of State and Defense to pull that off.

But one of the problems that we continually run into is that our competitors are able to come in and offer below-market rate financing. We would certainly support the development of some program—I don't know if Ex-Im is the proper location or not. We can't even compete with OECD rates, which are usually for eight years at 8.5 percent. Principal is usually forgiven the first two years, by the way. We can't compete with something like that. And yet, the last time I checked I believe the United States was a participating member within the OECD organization. Here is an international organization that has blessed this.

Now, in the case of the fish processing vessel conversions in Norway, they were talking about rates that were hovering around the 2 or 3 percent level. If that's what it takes to compete, we will come up and ask you to do that. I'm not sure that within the budgetary constraints you all have to face you can fit that in, but we are perfectly willing to come up and say, we cannot develop the export market in the face of people who are receiving these kinds of interest rate subsidies. And we need to be very up front about that, and I'm here to tell you that we are.

Mr. Lowry. Well, I think that's good.

In the case of the fish processing, I think when we pass H.R. 2598 we will be answering that particular question. But, of course, there are a lot of other commercial businesses we'd be interested in.

Thank you, Mr. Chairman.

Mr. Anderson. Well, thank you, Mr. Schaefer and Mr. Stocker and Ms. Kinter, for an excellent presentation.

Our final panel is a labor panel, Frank Pecquex, Legislative Director, Maritime Trades Department, AFL-CIO, and Bill Carpine, Secretary-Treasurer of the Seattle Metal Trades Council.

Your prepared statements will appear in the record immediately following your oral presentations.

In the case of Frank Pecquex, I guess you're going to be presenting Frank Drozak's statement. His statement will be made a matter of the record. You can proceed any way you wish.

STATEMENT OF FRANK PECQUEX, LEGISLATIVE DIRECTOR, MARITIME TRADES DEPARTMENT, AFL-CIO, CAMP SPRINGS, MD, ON BEHALF OF FRANK DROZAK, PRESIDENT, MARITIME TRADES DEPARTMENT, AFL-CIO

Mr. Pecquex. Thank you, Mr. Chairman. I am Frank Pecquex, representing the Maritime Trades Department, AFL-CIO, and also sitting in for Frank Drozak.

If I could, I'd just like to have Mr. Drozak's statement submitted for the record and then perhaps make some observations that I had the benefit of putting down as I sat back here waiting for the opportunity to speak.

First, I would like to thank the Committee membership in its entirety for its support for the maritime industry on the fleet trade agreement. I think that is in no small measure your support that led to the removal of the Transportation Services Annex from the Free Trade Agreement. Without the wholehearted support of this Committee, I don't think we would have been successful.

We would also like to thank you for holding this hearing today. It's the first time, I guess, that we've had a shipbuilding hearing in a while, and certainly the issue has to be addressed.

Without question, the shipbuilding industry is one which is vital to the Nation. Unfortunately, the state of the industry is one of much concern. We look at it from the labor point of view as the maintenance of jobs and the skill levels that are associated with the people who hold those jobs. The number of alien workers that have been found in shipyards on the East Coast and West Coast is now well documented and one in which, again, Congressional support has led to the removal of some, and we certainly would urge you to do that if it crops up once again.

Our efforts, though, are meaningless if there are no shipyards. There certainly are jobs tied in to the shipyards; unfortunately, if you lose both the manpower and the yards, you lose strategic capabilities. There is that basic question of being able to break out the Ready Reserve Force and repairing any vessels that might be damaged in any kind of national emergency that breaks out in the future.

I guess one of the things that we've been told by many people over the last couple of years is the fact that we, as labor, have to recognize that we're moving away from an industrialized nation to one which is a service economy-oriented nation. I don't think that we should accept as fact that in that process we are going to abandon any of our basic industries. Certainly, industries such as the maritime industry are needed for a variety of reasons. A deemphasis is something that perhaps we could accept, but I think the problem that we're faced with now is that we see no possibility, no program, on the horizon which is going to ensure that our industry—shipbuilding, ship repair, even the operation of vessels—is going to be around by the year 2000. And I think that's one of the points we'd like to make today.

I will not go into the depressed state of the industry. That's been well documented by the previous witnesses and by the previous studies that you are privy to. The latest, of course, is the Bennett Defense Commission which will be making its recommendations shortly.

I guess one of the basic problems as we see it, as maritime labor, is the failure to link the industry's commercial operations and its shipyards and its vessel operations with the Nation's defense needs. I guess the solution to that is a very basic one. It's one that you have wrestled with over the years. It would involve the question of Government financial support, as well as perhaps the one that has been most debated over the last several years, the question of free trade as it relates to international shipbuilding and shipping.

This, to me, is not a new linkage, Government funding and changing stands on free trade versus fair trade. Other industries seem to receive it and receive it rather routinely. If you look at a couple, the airline industries—the Department of Transportation has a set of negotiators whose main function in part is to ensure that landing rights are negotiated for American carriers overseas, as well as for foreign carriers to come into the United States. In my mind, that is nothing short of a bilateral shipping agreement that we would accept.

The trucking and heavy construction industries receive significant financial support. Any time any of us fill up our tanks, some of that money that we pay goes into trust funds that are taken out to be used at some point in time or another for the construction of our highway system, and certainly the justification for that in part has been the need for having a domestic transportation infrastructure. We support that.

I guess the most noteworthy in terms of the arguments in support of free trade—the continued necessity to survive with significant Government subsidy—is the agricultural industry, one which we unfortunately do battle with periodically and one which—we both are depressed and would like to work together more than we possibly do.

As a private citizen, I think I recognize all of the linkages between Government funding and the stated position on free trade, as a necessity for keeping those businesses in fine operating order because they are vital to the U.S. economy. As a maritime labor representative, I fail to understand the refusal of the Government to assist our industry to a greater extent than it does, recognizing the unique role that we play in terms of national defense.

I am certain that if we put pen to paper and were locked in a room any longer than we've been locked in now, we could probably come up with a means of developing a program. I don't think that we're suggesting that you turn over a blank check to the industry to resolve our problems. I think—if you look at what's going on downtown right now, a far weightier issue is being resolved, and that's the question of nuclear weapon disarmament. If you think about it for a moment, it would seem that it's going to add extra emphasis on conventional warfare because when you start to lessen the chance of a nuclear holocaust you put us in a greater position of having conventional warfare. One knows about the imbalance of conventional forces, especially in Europe between the Western and Eastern Bloc countries.

There are a number of solutions that we have in our statement. I'll just reel off a couple of them.

The 200-mile Exclusive Economic Zone—we certainly support the Americanization of it for the fisheries, for the platforms used in the discovery and production of oil fields offshore.

We've been supportive of a build-and-charter program for vessels that would have commercial application but would also be necessary or useful in times of national emergency for the Navy's use.

I think the title XI funding program must be maintained.

Certainly, we should look at the question of some naval ship repair work that is being sent overseas. More of it should be retained in the United States.

You have the sealift tanker question where the Navy is seeking replacement of a number of outdated product tankers. Certainly, we support that.

They are all on the table, and I'm sure that if we wanted to we could go on and on and on. All we would have to do is break out our previous testimony over the years.

So we have solutions. It's just a question of, do we have the will? Certainly, in this Committee there is a will.

I guess the final thing I would recommend is that there be better coordination between one of the other committees in the Congress, and that's the Armed Services Committee. Over the years we have periodically worked with the Armed Services Committee in terms of rebuilding our maritime industry, but I don't think we've actually linked the two as closely as we should. If one compares the membership of the Armed Services Committee and the Merchant Marine Committee, you'll find out that 25 percent of the Members of this Committee sit on the Armed Services Committee.

If there's any final word that I leave, I guess the only encouragement that I can offer is that perhaps in the next session of Congress we can call upon those Members of this Committee who sit on Armed Services, perhaps to work as a block and try to bring to that Committee our concerns which must be acted upon very soon or else we'll continue to decline.

Mr. Chairman, I thank you for the opportunity and will be here to answer questions.

[The prepared statement of Mr. Drozak may be found at the end of the hearing.]

Mr. ANDERSON. We'll hold questions until we have heard from both of you.

Mr. Carpine.

STATEMENT OF BILL CARPINE, SECRETARY-TREASURER, SEATTLE METAL TRADES COUNCIL, SEATTLE, WA

Mr. CARPINE. Mr. Chairman and committee members, I am Bill Carpine, Secretary-Treasurer of the Seattle Metal Trades Council, which is tied in with the Pacific Coast District Metal Trades Council. I'd like to give you a short background of my history and then go into my oral statement.

In the early 1960's, I started as an electrician, one of those skilled workers in the shipyards in the Seattle area. As of 1974, I became a business representative of the International Brotherhood of Electrical Workers and have been involved in the negotiations and the problems that we have faced in the shipbuilding industry since then.

With this and my statement today, we have heard a lot of things repeated. I will have a few things that I would like to emphasize and bring out, which are the problems within the Pacific Northwest, mainly Seattle.

Today, we've heard nothing but cost, cost, cost on the Navy. There are some problems in that the Navy has interfered with our collective bargaining in the Pacific Northwest. Even before our 1986-1987 negotiations with the shipbuilders on the Pacific Coast, the Navy had made it very clear to us in the San Francisco area that there was a travel pay allowance in our bargaining agreement. We were told by the shipbuilders in that area that the Navy would not pay for this travel pay allowance between San Francisco and Oakland.

During the early stages of our 1986-1987 negotiations, it was again brought to us by management across the table that we would have to take that travel pay allowance out of our agreement, that our pension funds were too high, that we would have to do something in this area. However, the Navy, at their Mare Island Yard in San Francisco, does enjoy travel pay allowances. We were to take these out.

It took us some time to realize what it was, and I have heard some stories here about the differential between East Coast, West Coast, and the Gulf Coast. I would like to set the record clear that labor did respond on the Pacific Coast, especially in the Portland and Seattle areas. Our base rates are now $12 an hour. We have a hiring rate of $10 an hour, and we have taken cuts in our health and welfare and pension. Today, Todd's has a $12 and $10 an hour hiring rate. Marine Powered Equipment in Seattle has a $12 rate. Tacoma Boat is $12 an hour. And yet, when I go into the San Francisco area, I see a rate of $13.65 an hour with no cuts in regards to their health and welfare. They seem to have a rather large abundance of work in the San Francisco area.

I feel that the Navy has treated us unfairly in the bidding procedures. These are just a few of the things that have happened to us there. The requirements that they have put upon us in the Seattle area—on September 30, 1986, the Navy informed Todd Shipyards in Seattle that they would no longer employ anyone in that area that was not a U.S. citizen. Today, you did hear about 109 Japanese and Filipinos that were brought into this country that were not U.S. citizens and that were allowed to work. I am sure that those people were cleared through security so that they could work, but I ask: why weren't we here in the United States given the same opportunity? We have plenty of skilled people in the Pacific Northwest, and we feel that we should be treated in the same manner.

I heard also today that there have not been any ships in foreign countries—United States Navy ships in foreign countries—for repair. I am sorry to report that I have heard and seen a United States ship, a cable layer that was sent into Vancouver, Canada, and was repaired. Later, that ship came back down into the Seattle area. I do not have the name of the ship right with me, but later I would be very willing to supply you with that information.

These are things that we think are very unfair. Not only has the Navy done that; but, during a period in San Francisco, the Navy allowed enlisted personnel to be hired by Continental Maritime and to perform work on that ship in San Francisco while we have people out of work.

Other things that we see in Seattle as far as the bidding procedures—this brings to my attention Lockport Marine. Today, I heard testimony that they would look into the consideration of skilled work forces, the capability of doing the work, and all. The U.S.S. *Fort Fisher* was awarded to Lockport Marine when Lockport Marine did not have any skilled people employed in that shipyard. The shipyard is in Portland, Oregon. I'm not positive if that award was given to Lockheed and then transferred down to Portland, but somehow Lockport Marine obtained that job with no skilled work force. That ship was one of the ships that was used in a comparison on competitive business between the private and the public shipyards. I think that's very unfair and should be looked into.

Lockheed was also awarded two air cushion vessels for the United States Navy. The engineering was done in the Seattle area by Lockheed and Todd. The combinations were put together. We in labor in Seattle had felt that that work would be done in Seattle; however, it was not. It was transferred to Louisiana, and it was built at a facility within miles of a contractor building a similar vessel within the same State. I don't believe that's in line with our national defense, but this was allowed in that area.

We heard the cost overrun question brought up in the Pacific Northwest. The General Accounting Office, according to our reports, showed that the nationwide average was 63 percent above the bid and only 35 percent in the Pacific Northwest areas.

Speaking of competition and what it means to us in the Pacific Northwest—and to the Navy, also—we have four shipyards in the Pacific Northwest, in Seattle. Lockheed, which is presently up for sale—the Pacific Coast Metal Trades Council met with Lockheed yesterday, and they have announced as of yesterday that it definitely is up for sale. They are selling all three of their yards, and they are getting out of the business. They will sell either one, two or three, so we can mark Lockheed off. We do hope to have a prospective buyer coming in to buy that facility.

Other than that, we have Tacoma Boat in Chapter 11. We have Marine Powered in Chapter 11, in which we are presently in an ESOP position, and we are hoping to pull this off and maintain that yard.

The other yard we have is Todd's, Seattle, which is presently in Chapter 11, and it needs some desperate help. Without this help, the United States Navy could very well find themselves with a home port in Everett, Washington, with no major shipyard in that port to do any work. I do believe they need two within that area to be competitive and do anything that they want.

There is one other problem that was brought up today. A question was brought up about the Canadian Free Trade Agreement. This involves the surimi fish processors that were talked about earlier, 70 of them. If we can't get the help that we need now, if it goes the way it is, Canada will also have a shot at that work. We need that work to maintain our skilled craft people within the Puget Sound area in case we have a national emergency. We feel we have an emergency in that area right now, and we need that work to carry us out. There is approximately five years of work that will keep our skilled workforce intact and keep us going until we can get into the repair business and get back on our feet in the Seattle and the Pacific Northwest areas.

I thank you for the opportunity to give my statement, and I will answer any questions.

Mr. ANDERSON. I think my first question is to you, Bill. To what do you attribute the fact that the West Coast and Gulf Coast have been especially hard-hit by the recession in the shipbuilding and repairing business?

Mr. CARPINE. I beg your pardon. Was that the West Coast?

Mr. ANDERSON. Yes, the West Coast and the Gulf Coast have been hit hard. What do you attribute that fact to?

Mr. CARPINE. I believe that the fact that we were hit hardest is because our wages were rather high. They were $13.50 with a $3.31 fringe package. I believe we could have been competitive, but the Navy was very stubborn and wanted us to cut our wages. They were going strictly for a cost package, not for the skills and abilities and things that we had in that area. But I do believe that's the main reason we were hit hard.

I did hear earlier today in a statement in regards to OSHA and the cost of OSHA—for years, the Pacific Coast Council has been crying that we are hit harder than anyone in regards to OSHA. I think a recent investigation out of the Bath Iron Works shows that it was very lax in that area and that we were hit very hard.

So, those are two things that I would consider that are hitting us hardest.

Mr. ANDERSON. Did I understand that you had, in the Seattle area, adjusted your wage scale so that you are now competitive with the Gulf area and some of the others? That Los Angeles is still a little bit higher, but you are competitive with New York?

Mr. CARPINE. Yes, we feel we are. We have $12-an-hour rates plus the $10-an-hour hire-in rates.

Mr. ANDERSON. My next two questions are for either of you.

First, are apprenticeship programs used in the United States and in foreign countries, and are they effective?

Mr. CARPINE. May I go first?

Yes, apprenticeship programs are intact in the Seattle area. At one point we had over 50 apprentices in Todd Shipyard alone, but in the Seattle area we've gone beyond the apprenticeship program. We've taken two cents an hour out of our pension and pushed this into a training fund to upgrade our journeymen and keep our skill levels above that of the average shipyard worker.

Mr. ANDERSON. I understand—this is for either of you, too—that many workers in the shipbuilding, ship repair, and attendant industries perform highly specialized tasks and are forbidden from performing other tasks. What impact do these cross-skill restrictions have on efficiency?

Mr. CARPINE. From practical experience on craft interchangeability—which you're speaking of, being able to do other crafts' work—I feel there are some areas where we could improve in the interchangeability. It's going to be a tough road to come to, but I think we also have to be very careful in our interchangeability that we don't get someone into an area that he is unfamiliar with and where he is incapable of performing the work. I have heard cases where electricians are allegedly waiting for 40 minutes or an hour for a welder to come by to do a simple packing job. We in labor do not feel that that is our problem. That's a poor management problem. We feel that, if they supply the work for us and schedule it properly, we can do it.

I don't think you'll find that. That's an old argument, and I don't think you'll find it taking place in the Pacific Northwest on that scale any more.

Mr. PECQUEX. I think generally speaking, too, Mr. Chairman, that that is the goal of all of the unions today. We recognize that we have to be competitive, and certainly from a shipboard point as well there's a movement toward this cross-utilization of workers. But I agree that you have to watch out that you don't water down the skill levels of all of the players so that they become inadequate to perform a quality job, which is the hallmark of U.S. ship construction.

Mr. ANDERSON. Mr. Lowry.

Mr. LOWRY. Thank you, Mr. Chairman.

Thank you both for your very helpful testimony. Frank, if we weren't under such a time limit here with a vote on, I'd ask you how much heat you get on your beard. I've been doing a lot of studying on this lately.

Mr. PECQUEX. I'll get a lot more if you ever shave yours off.

Mr. LOWRY. Well, you'd better get ready. [Laughter.]

Mr. PECQUEX. Thank you, Mr. Lowry.

Mr. LOWRY. You both listened to the line of questioning that many of us kept on today. I'm worried about the real cost of that ship to the Navy relative to the quality of the work.

I have talked, frankly, with many of the workforce that are working in the shipyards in the Seattle area, talking about the quality of work that we've seen, for instance, at Lockport Marine. Mr. Carpine, would you care to give any reports from what you've heard any of your members or anybody report to as to the quality of work that they've seen in the ships that have been subbed out to these less-skilled areas?

Mr. CARPINE. I could comment that I've talked to some of the supervision that went from Lockheed to Lockport. These are some old-time friends that I've worked with years back, and they were very disappointed that ahey were sent down to Lockport to have to perform the work down there, to supervise the work. They reported to us that the work was very sloppy. It would take them a tremendous amount of time to ever train these people to come up to par with the work they had in Seattle. I think it's very evident; Lockport is now closed.

Mr. LOWRY. Mr. Chairman, I know this is a line of questioning we have been pursuing in this hearing. That is one reason I appreciate so much your putting a priority on this.

Let me ask both of our panel members here, how important do you think it is to national security and the taxpayer that the Navy and the other Government agencies put a higher emphasis on looking at the quality of the work being done after the low bids are made? And what do you see in the future for us as far as an increase in needed repairs and needed upgrades as a result of us not doing an adequate job of really inspecting at this time?

Mr. CARPINE. I'll take that first, Mr. Lowry.

It's a shame that they take it on a low bid. As a taxpayer I am also concerned that they go back to the old method of really coming in and making sure that the skilled workforce is there, that the facility does have the means to do this particular job—any repair job, whatever it is—it's vital that the Navy does that. I think if they would come back and do that, I think you would find that we in Seattle would probably end up with one whale of a lot of work. We have a very, very highly skilled workforce in the Seattle area.

Mr. LOWRY. Yes, Mr. Pecquex?

Mr. PECQUEX. I think to some extent the low cost is a big problem, and I think that perhaps we would find that the Navy could—or the Government could, because it isn't just the Navy's money, it comes out of the Federal Treasury—if we had an overall shipbuilding program that rolled in commercial work with naval work, you would find the ability to lower the overhead cost in terms of naval ship construction. That would, I think, be a better way of lowering the cost to the Government than trying to skimp on the construction of the vessel. I think that if you just do it on a cost basis sooner or later you're going to have to pay the piper, and that piper is going to demand a lot more money in the final analysis before that vessel is taken out of service than if it would be attended to at the time of initial construction.

Mr. LOWRY. Well, if you're a main contractor and subbing out or going to a shipyard where they have less experienced and skilled workers, obviously they're not going to be paying quite the benefit package to those less experienced and skilled workers. But what's the end result, the real cost of that to the taxpayer?

Mr. CARPINE. I think that's unknown at this particular time because that vessel hasn't been out there long enough to see if it's going to stand up.

Mr. PECQUEX. There's a relationship in terms of the operation of the vessel, also. We've simply been finding crew cuts down to the point that all they're going to do is operate the vessel. They don't want to take care of maintenance of the vessel, and we are running into what we call "bicycle shop" operations, people who have no experience going out there and servicing the vessels. We say, add additional crewmembers. It may cost you a little bit of money up front but, in the long term, you're going to save a hell of a lot more money and have a better operational product.

Mr. LOWRY. Thank you. I think, again, that this testimony clearly shows that we ought to be putting a greater emphasis on that part of the bid process right now and doing a better job, which would save us money in the long run.

I'd like to thank the panel very much.

Mr. Chairman, I'd like to thank you for moving this hearing up on schedule and getting this going.

Mr. ANDERSON. I do everything you tell me, Mike. [Laughter.]

Thank you, Frank and Bill, for an excellent presentation. I think even more importantly, this concludes our session, and now we've got to go vote.

I do have one final request. I've just been given a statement by the Honorable John Gaughan, Maritime Administrator, for the record. If there is no objection, it will be made part of the record.

[The prepared statement of Mr. Gaughan may be found at the end of the hearing.]

Mr. ANDERSON. We stand adjourned.

[Whereupon, at 5:55 p.m., the Subcommittee was adjourned, to reconvene at the call of the Chair.]

[The following was received for the record:]

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December 7, 1987

TO: MEMBERS, SUBCOMMITTEE ON MERCHANT MARINE

FROM: Majority and Minority Staff

SUBJECT: Oversight Hearing on the Reduction in U.S. Shipbuilding and Ship Repair Capability

INTRODUCTION

At 1:00 p.m. on Tuesday, December 8, 1987, the Subcommittee on Merchant Marine will hold an oversight hearing on the reduction in U.S. shipbuilding and ship repair capability.

BACKGROUND

Since colonial times, American leaders have recognized the importance of the ability to build and repair vessels in the United States. However, except in times of war or national emergency, Americans have been reluctant to devote the resources needed to insure the strength of the shipyard mobilization base.

During the colonial period, population centers generally were located near water. Inexpensive timber found in coastal forests was used to build ships. Until late in the 1800's, in fact, water transportation was the easiest, most expeditious way to move people and goods. By 1850, the American merchant marine was the second largest in the world.

During the past 150 years, merchant ship construction in the United States has followed the fluctuating curve of national interest in maritime affairs. The turning point of the upward spiral for the American shipbuilding industry was the end of the Civil War. Thereafter, interest in shipping and the shipbuilding industry waned until passage of the Shipping Act of 1916. During and after the Civil War, important changes were taking place in ship construction. Vessels were being built of iron and propelled by steam, supplanting wooden hulls driven by wind and sail. Foreign shipbuilders, who had made rapid progress in technical developments and improvements while the Civil War was being fought, gained further advantages from lower labor, material, and other costs, compared with similar costs in the United States (a situation that exists to this day). The lag in American capability to bend iron sheets into large shapes to construct hulls in domestic shipyards also gave foreign shipyards superiority over their American counterparts.

In the years between the Civil War and World War I, the maritime industry reached its lowest point. In fact, because of the lack of adequate shipbuilding facilities and shipping services during the Spanish-American War, the United States had to buy ships from foreign countries to sustain its naval forces.

World War I brought home to the American people and to the Congress an understanding of the plight of the shipbuilding facilities and the inadequacy of the U.S. merchant marine. In 1914, U.S.-flag ships were employed largely in the coastal trade and carried approximately ten percent of American international trade. Today, U.S. ships carry less than five percent. The bulk of U.S. cargo was carried on British, French, German, and Italian vessels -- all of which were withdrawn from the U.S. commerce at the outbreak of the War. Without U.S. ships and the capacity to build them, crops rotted in the fields and surpluses were burned to save storage.

We began a feverish build-up of the shipyards in this country in response to the crisis. A massive shipbuilding program was implemented, including the construction of more shipyards. The shipbuilding industry, under the authority of the Shipping Act of 1916 and the stimulus of the war in Europe, delivered 1,409 ships, totaling 8 million gross tons, between 1916 and the end of 1921. Of that total, however, 1,033 ships or 5.9 million gross tons were delivered after the War was over.

After the War, yards were shut down, and vessels had to be disposed of. The Merchant Marine Act of 1920 was designed to facilitate the disposal of those surplus ships. That Act, in conjunction with the 1928 Merchant Marine Act, were designed to assist the development of U.S. merchant marine industries. Despite the incentives in the 1920 Act, only 28 ships were built between 1923 and 1928. All were for operation in the domestic trades. Forty ships were built between 1929 and 1933 in accordance with the construction loan and mail provisions of the 1928 Act. These were largely combination passenger/cargo vessels.

In the bleak years between the wars, only the strongest shipyards survived. These included Newport News Shipbuilding and Drydock, Federal Shipbuilding and Dry Dock, New York Shipbuilding, Sun Shipbuilding and Dry Dock, Bethlehem Steel Corporation, Electric Boat, and Bath Iron Works.

In 1935, President Franklin Roosevelt, in his message to Congress, expressed his strong support for the merchant marine and called the industry a national asset. Roosevelt's strong recommendation and support for strengthening the merchant marine, and the recognition by Congress that a more effective policy was needed to maintain an active maritime fleet, culminated in enactment of the Merchant Marine Act of 1936. The 1936 Act authorized the creation of the Maritime Commission as an independent agency. The Commission had as its charter the modernization of the U.S. merchant marine. This was to be accomplished in part through the use of direct subsidies.

Title V of the Merchant Marine Act, 1936 authorized the Commission to pay construction-differential subsidy (CDS) to reduce or eliminate the cost disparity that existed (and still exists) between U.S. and foreign shipbuilding prices. To be eligible for subsidy, vessels are required by the Act to be built in U.S. shipyards, owned by U.S. citizens, crewed by U.S. citizens, and operated under the U.S. flag in the foreign commerce of the United States.

When it became apparent that war was inevitable, the Commission formulated plans for a building program of 50 fast cargo ships over a ten-year period. The plan was of incalculable value when the war in Europe broke out in September 1939. It provided the foundation for the expansion of the American shipbuilding industry to World War II levels.

The Maritime Commission built 21 new emergency shipyards and created additional building ways in almost all of the existing private yards. The new yards remained under Government ownership but were operated by private companies. Including extensions in the older yards and the new yards that were built, the Commission financed 43 private shipyards and the Navy, 80 yards.

Within the first months of 1942, 82 merchant ships were torpedoed off the East Coast alone. In the entire War, 700 merchant ships were sunk at the cost of the lives of 5,600 merchant seamen. Shipbuilding became a feverish race between sinkings and construction. During the War, the capacity of the shipyards was expanded four times over. U.S. shipyards did not win that race until 1943, the year the industry reached its peak.

During the four-year period of the United States' involvement in World War II, American shipyards achieved the greatest progress in technical development, safety, and mass production. They produced the largest merchant fleet the world had ever known, and they produced it on time.

The years following the War were difficult for the shipbuilding industry. As has been the case in past wars, American-flag operators had the war-built ships with which to service the United States' domestic and foreign trades. The need to update their fleets to compete with newer, more efficient foreign-flag fleets was not felt until the huge aid programs declined. Government maritime programs, never a high priority in peacetime, gave little attention to the dangers of the merchant marine's growing obsolescence, and the shrinking share of foreign commerce carried by a diminishing U.S.-flag fleet.

Unlike World War II, the mobilization required for the Korean and Vietnam conflicts was a surge, rather than a full-scale mobilization. In an effort to stimulate shipbuilding during the

Korean conflict, the Maritime Administration (MARAD) ordered for Government account 35 ships of the new Mariner class. They were of excellent design, particularly configured for the cargoes that moved in the highly competitive liner trades and for military service. They were capable of 20 knots sustained speed, and these breakbulk ships set the standard for speed on all the major U.S. trade routes. The 35 Mariner vessels were constructed between 1952 and 1955.

Sealift capacity was used heavily in Korea and Vietnam. During the Korean conflict, U.S.-flag merchant ships carried 80 percent of the 25 million tons of basic supplies and five million soldiers and civilians that were transported to the war zone. During the Vietnam War, commercial ships transported 65 percent of the 85.7 million tons of cargo shipped to Southeast Asia between 1965 and 1972.

The tonnage and value of United States oceangoing exports and imports were growing larger each year, but American-flag ships were carrying a steadily decreasing share of those cargoes.

By 1969, the share of American oceangoing foreign trade carried by U.S.-flag ships in all services reached its lowest point in 50 years. For example, in 1947, the share of U.S.-flag cargo vessels engaged in foreign trade was nearly 60 percent; but, by 1970, the percentage had dropped to a mere 5.3 percent.

Few tankers were being built for operation in foreign trade, and virtually no bulk ships were being constructed. In the 14-year period, 1956 through 1969, United States shipyards delivered to American owners 268 ships, principally dry-cargo types.

With few exceptions, the shipbuilding industry found it difficult to survive with so few ships on order. Naval construction and repair, which had been so important for several of the larger yards, were being cut back.

On October 23, 1969, President Richard Nixon sent a message to Congress containing a maritime program to revitalize the merchant marine industry. The Merchant Marine Act of 1970 was signed into law on July 1, 1971. Among other provisions, the law authorized the construction in American shipyards over a ten-year period of 300 ships for operation in the U.S. foreign trade, and authorized the payment of construction- and operating-differential subsidies (ODS) to bulk carriers and tankers.

In 1970, naval work still dominated the shipbuilding and ship repair activities of commercial shipyards throughout our Nation. In that year, twice as many Navy ships were built as commercial vessels in private yards. Their relative importance in the shipbuilding industry, however, significantly changed with the passage of the 1970 Act. A substantial increase in orders for the construction of tankers and bulk carriers gradually increased the share of commercial jobs. In 1973, the value of shipbuilding and repair work equalled that of Navy work.

By mid-1974, our Nation's private yards were for the first time constructing more commercial ships than Navy ships; 93 merchant ships of various types were under construction or on order in contrast to 63 naval vessels. During 1974, 38 new commercial vessels were delivered. These included tankers, dry-bulk carriers, a containership, barge carriers, and break-bulk carriers. From 1971 to 1978, the shipyards spent over $25 million on capital improvements.

The bright hopes that passage of the 1970 Act engendered did not materialize. Unfortunately, the new program was initiated during a period when the international market for tankers and bulk carriers was demoralized. Charter rates were very low. The severe competition in the U.S. liner trades from increasing numbers of foreign-flag containerships eventually resulted in overtonnaging, and rate-cutting became prevalent. American operators were reluctant to order expensive ships when opportunities for profit were so uncertain.

The Arab oil embargo, which began in late 1973, and the subsequent disastrous quadrupling of oil prices in 1974 highlighted the energy problems confronting the United States and the rest of the world. Worldwide inflation and the slowing of economic growth affected trade, intensified shipping competition, and caused a substantial drop in orders for new ships from world shipyards, especially for tankers and bulk carriers. Expectations that American oil companies and heavy industry corporations would find the 1970 Act attractive enough to order tankers and bulk carriers from U.S. shipyards were not met.

Since 1936, the CDS program has provided cost parity to permit our vessels to compete against cheaper-built, foreign-flag vessels. Until 1973, this program was practical and cost effective. Since that time, worldwide shipping conditions have further distanced American shipyards' costs from their foreign competitors'.

Among the factors contributing to this cost differential are the fact that lesser developed countries have wage scales that are much lower than wage scales in the United States. In addition, many countries provide direct and indirect subsidies to their shipbuilding industries.

Since 1981, the Administration has not requested, nor has the Congress authorized, CDS funding.

STATUS OF SHIPBUILDING, SHIP REPAIR, MERCHANT MARINE WORK FORCE, AND SHIP SUPPLIER INDUSTRIES

An examination of the United States shipbuilding and ship repair industry reveals a sharp decline and several factors that have caused or contributed to it.

In the industry as a whole, between 1982 and 1986, approximately 52,500 jobs were lost; 76 shipyards and ship repair facilities were closed; and 22 building ways, 17 floating drydocks, 21 graving docks, and numerous plant facilities were lost. In August 1987, at least 15 of the surviving firms were operating under Chapter 11 bankruptcy protection

A major factor contributing to the industry's decline has been the virtual cessation of commercial ship construction in the United States. In 1980, 69 merchant ships were under construction in 15 American shipyards; today, no merchant ships are under construction in this country. (The last seagoing commercial vessel from an American shipyard, a container vessel Bay Shipbuilding launched for Sea-Land Corporation, was recently delivered.)

The lack of orders for commercial ships is directly attributable to a worldwide surplus of shipyards and merchant ships, the United States' inability to compete in terms of price with most foreign shipyards, little coastal or inland maritime work, the collapse of the offshore energy industry, and the CDS program's failure. Meanwhile, foreign shipyards often get various forms of government support or have steady government orders that help their yards keep production costs low.

Shipbuilding has tended to follow low-cost labor. American shipyards cannot compete with foreign shipbuilding firms that can use low-cost indigenous labor and cheaper materials or that get substantial support from their governments. Shipbuilding industries have been targeted for priority economic development in many Far Eastern countries. Government help for shipbuilding is also common in Western Europe.

With the demise of commercial ship construction in the United States, naval ship construction and repair are virtually all that remain for the industry. The Navy accounts for 90 percent of the workload in private shipyards today. New construction work is highly concentrated in fewer than a dozen shipyards, with most others in the industry operating at only a small percentage of plant capacity and often losing money in the process. Only the few shipyards with long-term Navy construction programs or repair yards located within major Navy home port areas appear to have a foreseeable steady workload.

The closing of 76 shipyards or repair facilities over the last five years has drastically reduced the shipbuilding and repair industry's ability to meet mobilization requirements.

Further, critical facilities such as graving docks, floating drydocks, and building ways have been lost along with the 76 firms. The long-term problem with losing shipyards and facilities is that, once they are converted to more profitable uses such as upscale housing, the cost of returning the waterfront property to shipbuilding and repair is prohibitive.

Closings also result in the loss of piers, cranes, and specialized shops (machine, pipe, electrical, sheet metal, etc.). Most of the machine tools and other plant equipment in closed facilities have either deteriorated beyond reactivation or been sold or scrapped.

When ships are not built in a shipyard for a long time, vital production worker and managerial skills are lost. Since 1982, over 52,500 production workers have lost their jobs because of shipyard closings or because of workforce reductions in operating shipyards. Between 1987 and 2000, about 11,000 more shipyard worker jobs are expected to be lost. The downturn in the shipbuilding industry has also resulted in a reduction in the number of naval architects and naval architectural firms in this country. Shipyard production workers and experienced shipyard managers are concentrated in the largest shipyards, which are primarily engaged in Navy new construction work. The five largest private shipyards and the eight naval shipyards employ about 65 percent of the total industry work force.

The West and Gulf Coasts have been affected most by the shipbuilding recession. Since 1982, 15 West Coast firms employing 5,300 production workers and 28 Gulf Coast firms employing 7,000 have closed. Consequently, shipyard manpower has been reduced to critically low levels in these regions.

Fifty to sixty percent of a commercial vessel's construction cost is spent outside the shipyard for machinery, equipment, and materials. Shipyard suppliers make up a small segment of the industrial base. As the manufacturing segments of the industrial base have withered, so have many of the key segments of the shipyard supplier industry. Here are some examples of how the drop in commercial business has effected ship material and equipment suppliers. Ship engine manufacturing has been cut in half since 1980. The Navy was so worried about the marine gear industry's depressed condition that it restricted procurement of some Navy reduction gears to domestic suppliers. The number of companies that make large marine propellers has fallen from eight to five since 1980. Fortunately, the electronic and electrical components industries are currently healthy. The U.S. steel industry has lost half of its capacity and market share since 1980.

Along with specific industrial capability, the supplier industry has lost the skilled labor, physical facilities, tooling, and support capability critical to specialized manufacturing. Like shipyard managers and skilled shipyard workers, skilled craftsmen cannot be trained overnight.

The Commission on Merchant Marine and Defense projected the status of shipbuilding, ship repair, the merchant marine work force, and the ship supplier industry in the year 2000. The Commission based its analysis on the requirement to build the ships needed to maintain a 600-ship Navy, to maintain and repair the fleet, and to perform known and projected Government and commercial work.

After the early 1990's, only six or seven shipyards will be building Navy ships over 400 feet long. Once the 600-ship program is complete, construction for the Navy will drop to a sustaining level. Unless new programs are initiated, the prospects for commercial shipbuilding will be virtually nonexistent. With ship construction limited to Navy work and concentrated in only six or seven shipyards, our Nation's ability to quickly build ships, particularly merchant ships, during time of war or national emergency will be seriously impaired, if not lost. If a war or national emergency breaks out in the year 2000, our Nation will search in vain for the modern facilities and experienced production workers and shipyard managers needed for mobilization. The United States lacks the shipbuilding and shipyard supplier capabilities needed to meet new construction requirements during mobilization in either 1987 or 2000.

Since the mid-1930's, numerous studies have addressed the issue of the exact defense requirements for the maritime industry. The most recent studies done by the Defense Department, other Government agencies, and the Commission on Merchant Marine and Defense verify that the long-standing problems of U.S.-flag shipping and the shipbuilding and repair industries have adversely affected the United States' national security capabilities.

The defense contribution expected from the maritime industries includes U.S.-flag ships to provide a major part of our strategic sealift; qualified personnel to man those ships as well as the ships in reserve status; and a shipbuilding and repair industry capable of supporting strategic sealift and the needs of combatant naval forces.

To meet strategic sealift requirements for a Southwest Asia conflict today, 300 standard dry-cargo ships and 155 handy-sized tanker equivalents (HSTE's) would be needed. Twenty-five U.S.-flag dry-cargo ships and 193 tankers would be needed for economic support shipping to meet our Nation's domestic trade requirements.

In the year 2000, the total requirement for a global war would be 440 dry-cargo ships and 350 HSTE's, with the domestic economic shipping requirement staying approximately the same as in 1987.

Three hundred seventy ships would be needed for international trade in support of economic requirements, but it is assumed those ships would be provided entirely by foreign sources. If the foreign ships were not available in the numbers required, the demands for U.S.-flag ships, American personnel, and shipbuilding industry support would be increased substantially.

The mobilization requirements placed on the shipbuilding and repair industry in both 1987 and 2000 would include reactivating the Ready Reserve Force, the National Defense Reserve Fleet, and inactive ships in Navy custody; installing sealift enhancement features on some merchant ships; repairing battle damage to Navy and merchant ships; handling ongoing maintenance and repair; and, during a prolonged conflict, constructing 240 Navy and 250 merchant ships.

Our allies' merchant fleets have declined dramatically. The shrinking NATO fleets' ability to meet commitments to the United States is a matter of great concern.

MAJOR APPLICABLE LAWS

Since the earliest days of our Country, the United States Congress has recognized the significance of a domestic shipbuilding industry. A number of laws have been enacted since the First Congress to preserve, develop, and assist the shipyards of our Country.

The cornerstone of American maritime policy is known as the Jones Act (section 27, Merchant Marine Act, 1920). Section 27 requires that the transportation of all merchandise between points or places in the United States be on vessels built in the United States, and owned and manned by U.S. citizens. Passengers transported between U.S. ports must also be carried on coastwise-qualified (Jones Act) vessels. The carriage of passengers is also governed by the Act of June 19, 1886 (46 App. U.S.C. 289).

Another significant law is the Merchant Marine Act, 1936. This Act provided, for the first time, a workable basis for building and maintaining a privately-owned fleet of merchant vessels. In its Declaration of Policy, the Act sets out the intended goal of having a U.S. merchant marine composed of the best equipped, safest, and most suitable types of vessels constructed in the United States.

Toward this end, the Act established the construction-differential subsidy program. Title V of the 1936 Act authorizes the Maritime Administration to pay construction subsidies to reduce or eliminate the cost disparity that exists between U.S. and foreign shipbuilding prices. The subsidy is the difference between shipbuilding costs in a U.S. shipyard and a reasonable estimate of costs in a foreign shipyard, but may not exceed 50 percent of the domestic costs. To be eligible for CDS, vessels must be built in U.S. shipyards, owned and crewed by U.S. citizens, and operated under the U.S. flag in our Nation's essential foreign commerce.

Title XI of the Merchant Marine Act of 1936 established the Federal Ship Financing Guarantee Program. As originally enacted, title XI authorized the Federal Government to insure private-sector loans or mortgages made to finance or refinance the construction or reconstruction of American-flag, American-built vessels. Title XI was amended in 1972 to provide direct Government guarantees of the underlying debt obligations, with the Government holding a mortgage on the equipment financed. The U.S. Government guarantees full payment to the lender of the unpaid principal and interest on the mortgage or obligation in the event of default by the vessel owners. The title XI program has been self-sustaining during the majority of its life. However, over the past few years, the fund has operated at a deficit, and the Maritime Administration has had to borrow money from the Treasury to cover these deficits. The title XI program has a legislative cap of $12 billion -- with $9.5 billion allocated to MARAD, $1.65 billion reserved for use by the Department of Energy in ocean thermal-energy conversion vessels and facilities, and $850 million authorized to guarantee the financing of fishing vessels by the National Oceanic and Atmospheric Administration.

In 1969, in recognition of the condition of the merchant marine, President Nixon sent up a maritime legislative proposal that was eventually enacted into law and is popularly known as the Merchant Marine Act of 1970. The 1970 Act gave primary consideration to developing the American shipbuilding industry.

The 1970 Act made important changes in the CDS program by opening the program to U.S.-flag vessels engaged in the carriage of dry- or wet-bulk cargoes in the foreign trade. The Act also reduced the maximum permissible CDS rate; before 1970, the rate was 55 percent of the vessel cost. After 1973, major changes in the shipping industry resulted in a worldwide shipbuilding slump requiring increased subsidy. In 1976, Congress raised the maximum CDS rate to 50 percent. A 1979 industry study done for the Shipbuilders Council of America, a 1977 MARAD study, and a 1980 contract study done for MARAD support the conclusion that a 50 percent CDS ceiling will not adequately compensate vessel operators for higher U.S. construction costs in the 1980's. The CDS program has been unfunded since 1981.

The Capital Construction Fund (CCF) was also established by the 1970 Act. It assists operators in accumulating capital to build, acquire, and reconstruct vessels through the deferral of Federal income taxes on certain deposits. The program allows operators in the foreign trades, the domestic noncontiguous trade, the Great Lakes trade, and the American fishing industry to deposit a portion of taxable income, certain earnings, and receipts into tax-deferred funds for the construction or reconstruction of ships in U.S. shipyards.

RECENT LEGISLATION

Last Congress, the Merchant Marine and Fisheries Committee addressed legislation to assist the shipbuilding industry. The major proposal would have established a build-and-charter program to construct militarily-useful commercial vessels in U.S. shipyards.

H.J.Resolution 465, the Fiscal Year 1986 Continuing Spending Resolution, set aside $852,100,000 in carryover funds for the construction of militarily-useful commercial vessels in domestic shipyards for operation by U.S. citizens under U.S. registry in the foreign trade. Chairman Biaggi introduced H.R. 4136, which would have authorized the expenditure of those funds, and would have established a military auxiliary revolving fund within the U.S. Treasury. Chairman Jones (H.R. 4146) and Mr. McKernan (H.R. 3798) introduced related measures.

Testimony received during the March 11, 1986 Merchant Marine Subcommittee hearing on H.R. 4136 and related bills established that, with the exception of Administration witnesses, support for the concept of the legislation was universal. (See Printed Hearings No. 99-39) The Administration challenged the cost-effectiveness of build-and-charter in comparison to continued expansion of the Ready Reserve Force. The Administration also opposed the legislation because of the potential need for future appropriations to continue the program.

At Full Committee Markup on June 4, 1986, Mr. Biaggi offered an amendment incorporating language similar to the text the Armed Services' Seapower Subcommittee had adopted. During Senate debate on H.R. 4515 (providing urgent supplemental appropriations for Fiscal Year 1986), the funds that had been earmarked to capitalize the build-and-charter fund were redirected for other purposes. In Conference, the House receded to the Senate position. No Committee of jurisdiction undertook further action on build-and-charter legislation in the Ninety-Ninth Congress.

Just last month, several provisions which are important to shipbuilding and ship repair yards were added to H.R. 1748, the Department of Defense Authorization Act for Fiscal Year 1988, in Conference (Conference Report 100-446).

The first provision would prohibit the Coast Guard from procuring vessels built in foreign shipyards. The prohibition currently applies to naval vessels and other military department vessels. The Coast Guard had argued that it was not a military department and that the prohibition did not apply to Coast Guard vessels.

The second provision would increase the rate of progress payments on contracts for repairing, maintaining, and overhauling nonnuclear naval vessels when the work is required to be performed in a year or less. The bill would change the rate for small businesses from 80 to 90 percent and the rate for other businesses from 75 to 85 percent.

Third, the provision would authorize the Secretary of the Navy to enter into long-term leases and charters for militarily-useful tanker vessels constructed in the United States. Current law prohibits the Department of Defense from entering into a lease agreement that extends beyond 18 months. This amendment is designed to stimulate the shipbuilding industry and save tax dollars.

The phrase "constructed in the United States" would mean that the vessel's major hull and superstructure components would have to be made in the United States; the vessel would have to be completely assembled domestically; and at least half of the cost of all major items of machinery, including the propulsion plant and components, not an integral part of the vessel's hull or superstructure, would have to be of U.S. origin.

H.R. 1748 was sent to the President on November 30, 1987. He signed the bill December 4, 1987.

ISSUES

- Is the United States' shipbuilding and ship repair capability sufficient to meet our commercial and military needs during peacetime and in the event of a war or national emergency?
- If our shipbuilding and ship repair capability is inadequate, what role should the Federal Government play in strengthening the shipbuilding and ship repair industry?
  - Should Government action include direct subsidies, cargo reservation, and tax incentives?
  - Can existing laws be amended, or is a comprehensive legislative proposal needed?
- In what condition are our allies' shipbuilding and repair industries?
- Have Federal Government procurement policies that emphasize bid price rather than value eroded industrial capacity and capability in the shipbuilding and repair industry?
- What action can industry take to strengthen its position in a highly competitive world market?
- What action can labor take to strengthen shipbuilding and ship repair capability while maintaining high safety standards?

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Majority: Cyndy Wilkinson/Melanie Barber - 63500
Minority: Kip Robinson/John Moran - 63492

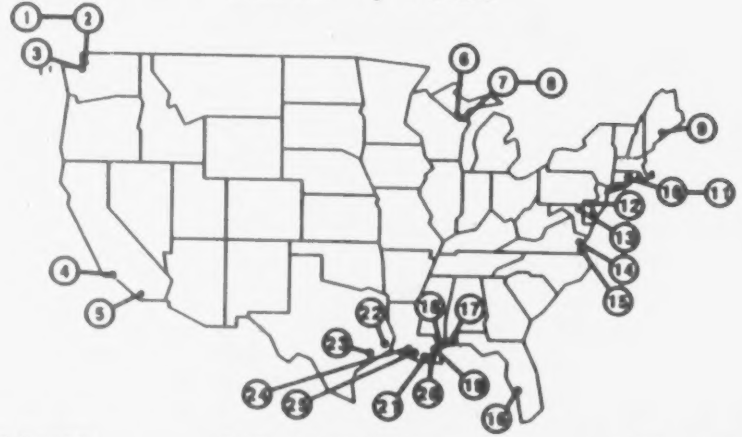
ENCLOSURES:

(1) Chart: Active U.S. Shipbuilding Base: June 1, 1987
(2) Chart: Number of New Commercial and Naval Ships Under Construction or On Order in U.S. Private Shipyards (1,000 Tons and Larger)
(3) Chart: Commercial Snip Orders Placed With U.S. Private Shipyards (1,000 Tons and Larger)
(4) List of Closed Shipyards (1980-1987)

DISTRIBUTION:

Members, Committee on Merchant Marine and Fisheries

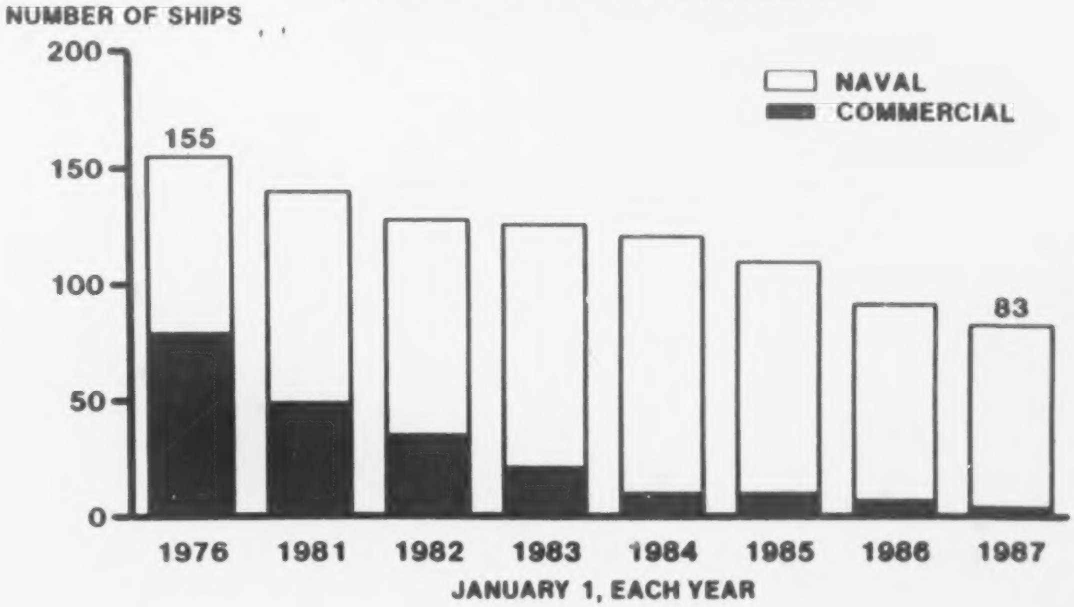
ACTIVE U.S. SHIPBUILDING BASE
JUNE 1, 1987



1. Todd-Seattle
2. Lockheed SB
3. Tacoma Boat
4. Todd-Los Angeles
5. National Steel
6. Marinette
7. Bay SB Corporation
8. Peterson
9. Bath Iron Works
10. R E Derecktor
11. GD-Electric Boat
12. Penn Ship
13. Beth-Sparrows Point
14. Newport News
15. Norfolk SB & DD
16. Tampa Ship
17. ADDSCO Industries
18. Litton-Ingalls
19. Avondale Shipyards
20. McDermott
21. Halter
22. Beth-Beaumont
23. Todd-Galveston
24. Textron
25. Moss Point Marine

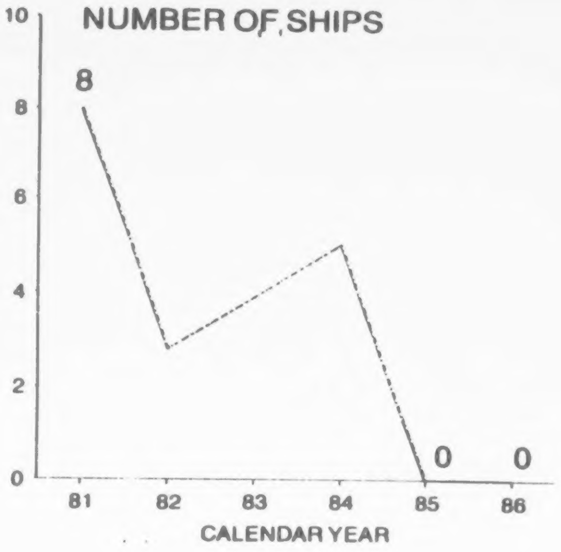
(SOURCE: Shipbuilders Council of America)

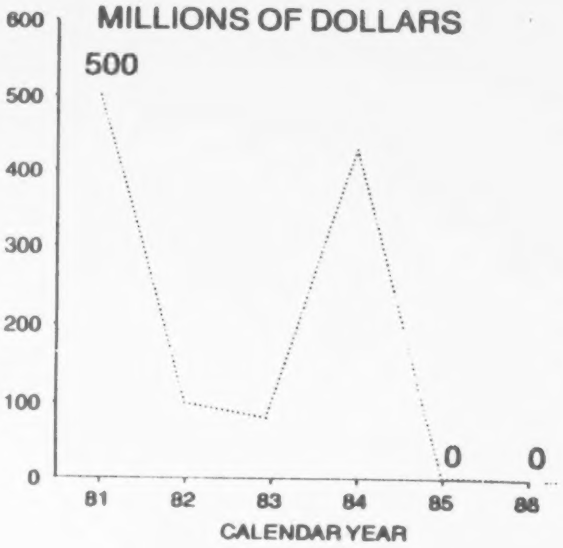
NUMBER OF NEW COMMERCIAL AND NAVAL SHIPS UNDER CONSTRUCTION OR ON ORDER IN U.S. PRIVATE SHIPYARDS (1,000 TONS AND LARGER)



(SOURCE: Shipbuilders Council of America)

COMMERCIAL SHIP ORDERS PLACED WITH U.S. PRIVATE SHIPYARDS
(1,000 TONS AND LARGER)





(SOURCE: Shipbuilders Council of America)

E-2

LIST OF CLOSED SHIPYARDS (1980 - 1987)

NAME	CLOSED	JOBS	FACILITIES			REMARKS
	Mon Yr	Max Prv 3	Build Pos	Dock Pos	L-Pier T-Pier	Comments/Information
A. Moe & Company, Inc. 808 North Front Street Philadelphia, PA 19123	JUL 86	40	NONE - -	NONE - -	NONE -	- - -
Allied Repair Service, Inc. P.O. Box 2236 Norfolk, VA 23501	- 85	355	NONE - -	F400 F100 -	500 1000	May be reopened by new operator; unable to confirm. Had Navy MSR.
American Shipbuilding Co.- CHI - Chicago, ILL	FEB 82	60	NONE - -	G694 - -	850 1300	- - -
American Shipbuilding Co.- LOR - Lorain, OH	- 83	930	G1021 - -	G708 - -	900 1800	- - -
Bergeron Industries, Inc. P.O. Box 39 St. Bernard, LA 70085	- 85	50	V370 - -	M300 F120 -	100 600	- - -
BFC Marine Service, Inc. Pier 5, Bldg. 56, Furman St. Brooklyn, NY 11201	- 86	20	NONE - -	NONE - -	NONE -	Had MARAD MLSR. - -
Boston Shipyard Corporation 256 Marginal Street East Boston, MA 02128	- 86	565	NONE - -	F670 F523 G256	1020 3111	Had G1176. Sold to a company to manufacture bridge sections only.
Burton Shipyard, Inc. P.O. Box 3636 Port Arthur, TX 77640	- 83	0	M200 - -	F270 - -	- -	South Gulf Terminal sold. -
California Shipbldg & DD Co. 1601 Water Street Long Beach, CA 90802	DEC 82	210	NONE - -	F389 F220 F200	326 739	Equipment from this yard sold to Southwest Marine, Inc.
Camden Ship Repair Co., Inc. Point and Erie Streets Camden, NJ 08102	MAY 86	60	NONE - -	M220 - -	NONE -	Sold to E.J. Brenneman Co. Not used for ship repair. Had Navy MSR.

SOURCE: First Report of the Commission on Merchant Marine and Defense: Appendices, dated 30 September 1987
-- Appendix E: Shipbuilding and Repair Industry and Supplier Base

LIST OF CLOSED SHIPYARDS (1980 - 1987)

NAME	CLOSED Mon	CLOSED Yr	JOBS Max Prv 3	FACILITIES Build Pos	FACILITIES Dock Pos	FACILITIES L-Pier T-Pier	REMARKS Comments/Information
Canal Marine Repairs, Inc. P.O. Box 8097 New Orleans, LA 70182	-	-	45	NONE - -	M100 - -	320 320	Had Navy MSR. - -
Chicago Bridge & Iron Co. 10 Washington Avenue Pascagoula, MS 39567	JUL	86	800	NONE - -	NONE - -	650 650	Facilities now in care and maintenance. -
Coastal Drydock & Repair Corp. Bldg. 292, Brooklyn Navy Yard Brooklyn, NY 11205	NOV	86	998	NONE - -	G1092 G1092 G760-2	1400 5740	Also had G465, G349. Company in bankruptcy. -
Delta Shipyard, Inc. P.O. Box 101 Houma, LA 70361	-	85	131	W300 W250 W120	F340 - -	1200 1200	- - -
Dillingham Ship Repair P.O. Box 4367 Portland, OR 97208	JUN	87	500	AVAIL - -	AVAIL - -	AVAIL -	Used facilities at the Portland Ship Repair Yard.
Dravo Corporation 4800 Grand Avenue Pittsburgh, PA 15225	APR	84	1550	W600-X W300-6 W300-5	M300 - -	350 650	Had twelve 600′ ways. Company exists; does not build ships.
Dredgemaster International Co. - Hendersonville, TN	SEP	84	0	- - -	- - -	- -	- - -
Florida Ship Repair, Inc. 1825 Knox Road Tampa, FL 33605	-	-	0	NONE - -	NONE - -	NONE -	- - -
Florida Ship, Inc. 2215 N.W. 14th Street Miami, FL 33125	-	84	0	NONE - -	F??? - -	- -	Had a 1000 ton capacity floating drydock.
General Dynamics Corp.- Quincy 97 East Howard Street Quincy, MA 02169	JUN	86	6000	G936 G860-2 G850-2	NONE - -	820 4530	Property is for sale. - -

LIST OF CLOSED SHIPYARDS (1980 - 1987)

NAME	CLOSED		JOBS	FACILITIES			REMARKS
	Mon	Yr	Max Prv 3	Build Pos	Dock Pos	L-Pier T-Pier	Comments/Information
Geosource, Inc. - Marine Div. 4040 Peters Road Harvey, LA 70059	AUG	84	50	NONE - -	M400 F195 F156	- -	Also had F138, F120 and F100. -
Golten Ship Repair, Inc. - Portland, ME	-	-	18	NONE - -	NONE - -	NONE -	Had Navy MSR. - -
Guntert & Zimmerman, Inc. P.O. Box 1688 Stockton, CA 95201	-	-	150	V400 - -	- - -	- -	- - -
Halter Marine, Inc. - Chef Hwy 19501 Chef Highway New Orleans, LA 70129	MAR	85	0	W194-3 W225-2 -	NONE - -	- -	Closed; no work. Some property sold to Textron Marine Ind.
Halter Marine, Inc.- Chalmette P.O. Box 29266 New Orleans, LA 70189	MAR	85	48	W160 W110 -	NONE - -	NONE -	Sold to an offshore supply co. in '85; not used as a shipyard.
Halter Marine, Inc.- Chickasaw P.O. Box 11338 Chickasaw, AL 36611	AUG	86	1200	W500 W150 -	F220 - -	650 1200	Placed in a care and maintenance status in August 1986.
Halter Marine, Inc.- Lockport P.O. Box 278 Lockport, LA 70182	AUG	86	400	W210 W210 W210	NONE - -	230 920	Placed in a care and maintenance status in August 1986.
Halter Marine, Inc.-Madisonvle Highway 21 Madisonville, LA 70447	AUG	86	630	W350 W200 W200	NONE - -	260 460	Placed in a care and maintenance status in August 1986.
Hawaiian Tuna Packers P.O. Box 238 Honolulu, HI 96809	JUN	86	419	NONE - -	NONE - -	220 220	Company in business but does not repair ships or boats.
Hidden Harbor Boat Works, Inc. 6111 East 21st Street Bradenton, FL 34203	-	85	42	NONE - -	NONE - -	NONE -	Small boat builder only. -

LIST OF CLOSED SHIPYARDS (1980 - 1987)

NAME	CLOSED Mon Yr	JOBS Max Prv 3	FACILITIES Build Pos	 Dock Pos	 L-Pier T-Pier	REMARKS Comments/Information
Horne Brothers, Inc. 2408 Harbor Road Newport News, VA 23607	DEC 83	414	NONE - -	NONE - -	665 1256	Land sold. Some assets bought by Newport News Shipbuilding & DD Co.
Hudson Engineering Company 520 York Street Elizabeth, NJ 07201	- 85	141	NONE - -	NONE - -	NONE -	- - -
Hudson Shipbuilders, Inc. P.O. Box Q Pascagoula, MS 39567	APR 85	624	W235-2 W130-2 W185	NONE - -	300 580	- - -
Hunt's Steelship, Inc. Route #4, Box 76 Pine Bluff, AR 71602	JUN 86	0	W120 - -	NONE - -	110 140	Had only 12 employees in July 1985. -
Ingalls Marine, Inc. P.O. Box 368 Decatur, AL 35602	- 83	90	NONE - -	G496 - -	500 500	Facilities now in care and maintenance. -
Inland Marine Constructors Inc P.O. Box 5516 Evansville, IL 47715	JUN 86	50	W200 - -	NONE - -	NONE -	All facilities and assets sold. -
Ira S. Bushey & Sons, Inc. - Brooklyn, NY	- 81	130	NONE - -	F455 F300 -	786 4086	- - -
Jeffboat, Inc. P.O. Box 610 Jeffersonville, IN 47130	JUL 86	871	W500 - -	F200 F200 -	2100 4980	Facilities now in care and maintenance. -
Kaiser Steel Corp. - Napa P.O. Box 390 Napa, CA 94559-0390	JUN 86	1696	NONE - -	G383 G300 G268-2	500 500	- - -
Levingston Shipbuilding Co. P.O. Box 968 Orange, TX 77631-0968	- 85	1450	W1100 W760-2 W180	NONE - -	520 1850	Has been in care and maintenance since 1985.

LIST OF CLOSED SHIPYARDS (1980 - 1987)

NAME	CLOSED	JOBS	FACILITIES			REMARKS
	Mon Yr	Max Prv 3	Build Pos	Dock Pos	L-Pier T-Pier	Comments/Information
Lockport Marine Company 5555 N. Channel Ave., Bldg.#10 Portland, OR 97217	JUL 87	300	AVAIL - -	AVAIL - -	AVAIL -	Used facilities at the Portland Ship Reapir Yard.
Luther's Marine & Industrial 3505 Franklin Street Chesapeake, VA 23324	OCT 86	12	NONE - -	NONE - -	NONE -	Survey form returned. Phone disconnected. -
Marine Concrete Structures Inc 2030 St. Charles Avenue New Orleans, LA 70130	JUN 85	0	NONE - -	G350 - -	- -	Yard located in Port Bienville, MS. -
Marine Ways Corporation P.O. Box 10464 Portland, OR 97210	- -	120	NONE - -	M??? - -	- -	Had a small marine railway. -
Maryland Shipbuilding & DD Co. P.O. Box 537 Baltimore, MD 21203	JUL 84	1737	V600 - -	F775 F650-2 F200	987 5106	Had Navy MSR. Now used by Toyota Motors for import operations.
Matton Shipyard, Inc. P.O. Box 645 Cohoes, NY 12047	APR 83	80	V150 - -	NONE - -	250 375	- - -
Maxon Marine Industries, Inc. P.O. Box 69 Tell City, IN 47586	FEB 86	105	V??? - -	M??? - -	- -	Had 6 building ways and a 500 ton capacity marine railway.
McDermott Int'l - Gulfport SY P.O. Box 2249 Gulfport, MS 39503	- 85	0	NONE - -	F160 - -	- -	- - -
McDermott Int'l-New Iberia SY P.O. Box 128 New Iberia, LA 70560	- 85	0	NONE - -	F180 F160 -	- -	- - -
Merritt Ship Repair Company - Oakland, CA	- 81	80	NONE - -	F320 - -	600 1155	- - -

LIST OF CLOSED SHIPYARDS (1980 - 1987)

NAME	CLOSED	JOBS	FACILITIES			REMARKS
	Mon Yr	Max Prv 3	Build Pos	Dock Pos	L-Pier T-Pier	Comments/Information
Misener Industries, Inc. P.O. Box 13625 Tampa, FL 33681	- 85	209	W600 - -	F210 - -	450 1350	- - -
Munro Drydock, Inc. 1 Winnisimmit Street Chelsea, MA 02150	DEC 84	78	- - -	- - -	- -	All facilities sold. Had Navy MSR. -
Paducah Marine Ways, Inc. P.O. Box 2305 Paducah, KY 42001	JAN 84	0	NONE - -	F200 - -	- -	New construction equipment scrapped; repair equipment sold.
Perry Shipbuilding Company P.O. Box 1318 Erie, PA 16512	NOV 86	130	NONE - -	NONE - -	1000 5300	Property sold to land developer in Nov. '86. -
Port Richmond Shipyard - Richmond, CA	- 85	200	NONE - -	G744 G583 G571-3	1560 2100	- - -
River & Offshore Services P.O. Box 474 Violet, LA 70092	- 86	0	NONE - -	NONE - -	1200 2000	Maintains lay-berths only. No longer does any repair work.
RMI, Inc. 1313 W. 24th Street National City, CA 92050	OCT 86	250	NONE - -	NONE - -	NONE -	Assets liquidated via Chapter 7 bankruptcy. Had Navy MSR.
Rumsey Marine & Drydock Co. Route 3, Box 6 Wilmington, NC 28405	- 80	52	W200 - -	F200 - -	450 900	Formerly North Carolina Shipbuilding & Drydock Co.
Savannah Shipyard Company P.O. Box 787 Savannah, GA 31402	SEP 84	357	W150 W350 -	G520 - -	362 793	Building ways have not been used since prior to 1980. Had Navy MSR.
Sea-Tac Alaska Shipbldg. Corp. 1112 Alexander Avenue Tacoma, WA 98421	- 83	76	W250 W150 -	F215 - -	175 175	- - -

LIST OF CLOSED SHIPYARDS (1980 - 1987)

NAME	CLOSED		JOBS	FACILITIES			REMARKS
	Mon	Yr	Max Prv 3	Build Pos	Dock Pos	L-Pier T-Pier	Comments/Information
Sherman Shipyard, Inc.	-	-	20	NONE	NONE	NONE	-
-				-	-	-	-
Panama City, FL				-	-		-
Teh Tung Steamship Company	MAY	84	30	NONE	F600	840	-
-				-	-	840	-
Orange, TX				-	-		-
Texas Gulfport Shipbuilding Co	JUN	85	200	W550	F325	590	Was a subsidiary of
P.O. Box D				W400	F325	1270	Levingston Industries,
Port Arthur, TX 77640				-	-		Inc.
Texas Shipbuilding Company	-	80	204	W450	NONE	300	-
P.O. Box 24787				W265	-	525	-
Houston, TX 77013				-	-		-
Thomas Knutson Shipbldg. Corp.	-	-	35	W300	M???	128	Had 60 and 40 capacity
East Shore Road				-	M???	450	marine railways, and a
Halesite, NY 11743				-	-		Navy MSR.
Todd Shipyards Corp.- Alameda	-	83	550	NONE	F900'	800	Todd moved to the
-				-	F523	2485	former Bethlehem Steel
Alameda, CA				-	-		yard in San Francisco.
Todd Shipyards Corp.- Houston	JUL	83	392	W500	F600	1844	Remains in a care and
P.O. Box 9666				-	-	3200	maintenance status.
Houston, TX 77015				-	-		-
Todd Shipyards Corp.-New Orlns	JAN	86	350	NONE	F544	1725	Facility is for sale.
P.O. Box 6158				-	F544	3756	-
New Orleans, LA 70174				-	F285		-
Tracor Marine Inc.	MAR	87	280	NONE	S360	780	Had Navy MSR.
P.O. Box 13107 Everglades Sta.				-	F300	1305	-
Fort Lauderdale, FL 33316				-	F270		-
Trans Ocean Shipyard	-	-	0	NONE	NONE	70	-
P.O. Box 4197				-	-	140	-
Brownsville, TX 78520				-	-		-

LIST OF CLOSED SHIPYARDS (1980 - 1987)

NAME	CLOSED	JOBS	FACILITIES			REMARKS
	Mon Yr	Max Prv 3	Build Pos	Dock Pos	L-Pier T-Pier	Comments/Information
Triple A South 3350 Main Street San Diego, CA 92113	OCT 86	400	NONE - -	F389 - -	NONE -	Equipment transferred to San Francisco. In care and maintenance.
Twin City Shipyard, Inc. P.O. Box 43632 St. Paul, MN 55164	MAY 86	130	W300 - -	M225 F100 -	1200 1650	- - -
Weaver Shipyards P.O. Box 1487 Orange, TX 77630	JUN 86	30	W200-5 W200-5 -	M200 M180 F180	220 730	Owner said he would write a letter to Secretary Dole.
Wiley Mfg. Co.- Equip.Sys.Div. P.O. Box 97 Port Deposit, MD 21904	SEP 84	526	W390 W340 -	NONE - -	NONE -	- - -
Willamette Iron & Steel Co. 2800 N.W. Front Avenue Portland, OR 97210	- 81	430	NONE - -	F1000 F763 F550-2	1200 1200	- - -
Zidell Explorations, Inc. 3121 S.W. Moody Avenue Portland, OR 97201	AUG 84	0	NONE - -	NONE - -	NONE -	Yard equipment is for sale. -

C O P Y

CONGRESSIONAL RECORD
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"Will the Last Commercial Shipbuilder Please Turn Out the Lights"

Hon. Mario Biaggi of New York

Mr. Speaker. Largely unnoticed amid the sweep of major events on Wall Street and the Persian Gulf, our Nation's first industrial enterprise, commercial shipbuilding, is sinking into oblivion. From New York to Baltimore, and Los Angeles to Seattle, everywhere we see the quickening pace of redevelopment of former shipyards into upscale condominium projects. Shipyards are closing their doors forever because of a combination of failed national policy and the fact that the land they occupy is worth more if converted to nonmaritime use.

It isn't just the land and facilities that are passing from the industrial seascape of our major ports. A recently released report of the Presidential Commission on Merchant Marine and Defense graphically chronicles the irreversible loss of skilled manpower. Seven short years ago, 50,000 shipyard workers were employed building commercial vessels. Now, no more. Gone forever.

This grim report coincides with the delivery of the last seagoing commercial vessel from an American shipyard -- a container vessel launched by Bay Shipbuilding for Sea-Land Corp. destined for a trading life on the Alaskan run. Remember her. Like as not, she will be the last of her kind. Save the champagne. We won't need it anymore.

I'd like to know what Jack London, Richard Henry Dana, or Herman Melville would say about the irreversible loss of America's maritime heritage and tradition, forever consigned to reside in the Smithsonian or Mystic Seaport. It just somehow seems all wrong. Worse yet, we may never miss it until it's gone; as I said before, drowned out in the maelstrom of Wall Street and the Persian Gulf.

QUESTIONS SUBMITTED BY THE HONORABLE MIKE LOWRY, MEMBER, COMMITTEE ON MERCHANT MARINE AND FISHERIES, TO THE DEPARTMENT OF THE NAVY; ALONG WITH ANSWERS FURNISHED BY THE DEPARTMENT OF THE NAVY

TESTIMONY FROM THE GENERAL ACCOUNTING OFFICE RAISES SOME CONCERNS ABOUT NAVY CONTRACTING POLICIES. ACCORDING TO GAO, MANY NAVY SHIPBUILDING CONTRACTS ARE AWARDED AT COSTS BELOW WHICH THE NAVY'S OWN ESTIMATES PROJECTED THE CONTRACT COULD BE COMPLETED. ADDITIONALLY, MANY OF THE CONTRACTS GAO EXAMINED EXPERIENCED SIGNIFICANT COST OVERRUNS. WHILE THE NAVY MAY BE SAVING MONEY UP FRONT THE ADDITIONAL COSTS RESULTING FROM OVERRUNS, OR THE NEED TO MOVE THE JOB IF A SHIPYARD SIMPLY CAN'T AFFORD TO COMPLETE THE JOB, SEEM TO OUTWEIGH THE PERCEIVED BENEFITS FROM SECURING LOW CONTRACT AWARDS. IN THESE TIMES OF RESTRICTED BUDGETS THE SITUATION APPEARS EVEN MORE CRITICAL.

SHIPBUILDING CONTRACTS

QUESTION: How many Navy shipbuilding contracts have been awarded at cost below which the Navy's own estimates showed the contract could be completed?

ANSWER: During FY 87, the Navy awarded 15 shipbuilding contracts for 9 ship construction programs (CG-47, DDG-51, TAO, TAGOS, and LCAC Classes were multiple awards). The contracts for all 9 construction programs were awarded at target prices less than or equal to the amounts budgeted for those programs.

QUESTION: Does the Navy have any plans to change the method of awarding contracts?

ANSWER: Navy shipbuilding contracts are awarded in accordance with applicable law and regulations. The Navy does not plan to deviate from statutory and regulatory requirements.

MERCHANT MARINE

QUESTION: I understand the Navy plans to review the recommendations from the Commission on Merchant Marine and Defense. Will the Navy consider making changes at that time?

ANSWER: Yes. The Navy will consider making changes, as appropriate, following review of the Commission's reports.

LOW-BALLING

QUESTION: There is a growing concern that the current "low-balling" climate for Navy shipbuilding contracts may be contributing to the closure of additional shipyards and result in the further erosion of our mobilization base. The West Coast shipyards have been particularly hard hit and I am concerned that the geographical diversity of our shipyard mobilization base is being compromised. What plans does the Navy have to ensure the survival of West Coast shipyards?

ANSWER: The Navy's competitive policies have maximized opportunities for domestic shipyards to participate in U.S. Navy new construction and repair work. However, the Navy construction and repair budgets are not, by themselves, adequate to sustain the entire domestic ship construction and repair capacity. West Coast shipyards have been and will be solicited for such work to the extent practicable.

SPLIT AWARDS

QUESTION: Is the Navy splitting awards to ensure viable yards on all our coasts?

ANSWER: The Navy will consider a split award in the interest of national defense and industrial mobilization and to ensure effective competition. However, a split award does not necessarily ensure maintenance of viable yards on all coasts.

MOBILIZATION BASE

QUESTION: Does the Navy consider the need for a diverse geographical shipyard mobilization base when awarding shipbuilding contracts?

ANSWER: Mobilization base is a consideration when awarding shipbuilding contracts, but awards are generally made on the basis of cost and technical considerations.

LOSS OF WEST COAST YARDS

QUESTION: Is the Navy concerned with the loss of West Coast shipyards?

ANSWER: Yes. The Navy is concerned with the trends toward losses and reduced workload at shipyards across the entire United States, including the West Coast. However, given the amount of shipwork in the FYDP the lack of commercial shipbuilding, and the impact of current fiscal constraints, the Navy is unable to satisfy its shipwork requirements alone are not adequate to ensure survival of shipyards throughout the United States.

IN A RECENT NEWSPAPER ARTICLE, THE NAVY REPORTEDLY IMPORTED FOREIGN SHIPYARD WORKERS FROM JAPAN AND THE PHILIPPINES TO WORK IN THE NAVY YARDS IN LONG BEACH, CALIF. AND PHILADELPHIA.

FOREIGN WORKERS

QUESTION: With so many of our own U.S. shipyard workers out of work why did the Navy import these workers?

ANSWER: The Philadelphia and Long Beach Naval Shipyards had heavy short-term workloads in specific trades and had been unsuccessful in their extensive efforts to recruit the necessary temporary skilled workers from local labor sources. The shipyards attempted to borrow personnel from other Naval shipyards, but this effort resulted in only eight electronics mechanics being assigned to Philadelphia Naval Shipyard from Pearl Harbor Naval Shipyard. Both shipyards also placed advertisements in local newspapers, coordinated their efforts with state unemployment agencies and requested assistance from the local unions. Unfortunately, all of these recruitment efforts fell short of the actual requirements. The rationale for using foreign employees of the U.S. Government at the U.S. Navy Repair Facility in Yokosuka, Japan and from Subic Bay was twofold: First, to provide skilled workers to assist the shipyard in critically overloaded areas, and secondly, to provide specialized training for these workers to better equip them to perform emergent repairs on Navy ships in the Western Pacific.

QUESTION: Under what authority did the Navy import these workers?
ANSWER: Workers from the Navy Ship Repair Facilities at Yokosuka, Japan, and Subic Bay, Republic of the Philippines, were brought in under the authority of the Master Labor contracts between the United States and Japan and the United States and the Philippines.

QUESTION: Does the Navy have plans to attempt this in the future?
ANSWER: The Navy has no plans to borrow workers from the Navy Ship Repair Facilities in the future. Navy Ship Repair Facilities do request to have their workers trained in one of our shipyards. This practice will continue.

MHC 51 CLASS

QUESTION: What is the status of the Navy's plans to build a coastal minehunter vessel?
ANSWER: The MHC 51 Class lead ship detail design and construction contract was awarded to Intermarine USA in May 1987. Intermarine USA, located in Savannah, Georgia, is a joint venture between Intermarine SpA, the Italian designer and builder of the LERICI Minehunter, and Hercules Aerospace Corporation. Ship construction is scheduled to commence in May 1988 and delivery of the ship is planned for April 1991. The Navy plans to competitively award the next two ships of the class in FY 89 with at least one of these ships being awarded to a second source.

QUESTION: Does the Navy still plan to build this vessel in Italy?
ANSWER: The Appropriations Committee Conference Report of 15 October 1986 directed that all ships of the class be constructed in the United States.

QUESTION: Have U.S. shipbuilders been allowed to participate in the bid process for this vessel?
ANSWER: The Appropriations Committee Conference Report of 15 October 1986 authorized the Navy to award the lead ship sole source to a U.S. division of Intermarine. This was allowed to ensure that Intermarine's unique glass reinforced plastic ship construction technology was applied to this design as developed and proven through the construction of 10 LERICIs for three navies. The two FY 89 ships will be fully competed with a second source selected and awarded at least one ship. The remaining ships of the class will be competed between Intermarine USA and the second source.

LOW-BALLING

QUESTION: With the "low-balling" of Navy shipbuilding contracts comes an increase in subcontracting jobs on these ships. What impact might this have on the quality of these ships?
ANSWER: Quality standards are imposed on the shipbuilders, who are responsible for ensuring that any subcontracted work complies with the same standards.

SUBCONTRACTING ON MHC 51

QUESTION: Are vessel delivery schedules remaining timely?

ANSWER: The lead MHC 51 Class ship contract is the only one awarded to date and an April 1991 delivery remains as scheduled.

LOW-BALLING

QUESTION: With the "low-balling" of Navy shipbuilding contracts comes an increase in subcontracting jobs on these ships. Is this subcontracting reducing the number of available shipyard workers vital to our national security?

ANSWER: We have no data supporting or refuting the contention that "low-balling" has impacted the number of available shipyard workers.

SHIPYARD MANPOWER

QUESTION: Shipyard manpower, both managerial and production workers, has been reduced to critically low levels, especially on the West and Gulf Coasts. What plans does the Navy have to ensure the availability of U.S. shipyard manpower?

ANSWER: Shipyard manpower appears adequate to meet Navy peacetime shipbuilding requirements under the current FYDP. The long term effects of continuation of the downward trends in shipyard manpower are unknown, but appear unfavorable. Navy analysis of the ability of the shipbuilding industry to meet mobilization requirements is in process. Navy planning in these areas, if required, would be developed upon completion of the analysis.

DURING NAVY TESTIMONY BEFORE THE SEAPOWER SUBCOMMITTEE OF THE HOUSE ARMED SERVICES COMMITTEE ON MARCH 5, 1987, VICE ADMIRAL WILLIAM H. ROWDEN, U.S. COMMANDER OF NAVAL SEA SYSTEMS COMMAND STATED: "WE HAVE NO CONTRACT CLAIMS FOR NAVY SHIPBUILDING PROGRAMS AT THIS TIME".

SHIPBUILDING CONTRACTS

QUESTION: What is the current status of shipbuilding claims against the Navy? Specifically, 1) How many are there?; 2) For what amounts?; and 3) Are the claims on the contracts which the Navy had identified, at the time of award, as being below actual costs?

ANSWER: As of the 31 December 1987 Report Period, there are 16 shipbuilding claims totalling $9,611,910, broken down as follows:

Contract NR	Company	Ship	Amount of Claim
N00024-77-C-2220	Newport News	SSN 716-718	$1,305,377
N00024-81-C-2022	Peterson	ARS-50	127,946
N00024-81-C-2022	Peterson	ARS-50	381,777
N00024-81-C-2022	Peterson	ARS-50	736,940
N00024-81-C-2022	Peterson	ARS-50	122,169
N00024-84-C-2078	Marinette	MCM-4	3,064,592
N00024-83-C-2094	National Steel	TAH-19	59,723
N00024-83-C-2094	National Steel	TAH-19	228,713
N00024-83-C-2094	National Steel	TAH-19	56,105
N00024-84-C-2005	Bath Iron Works	CG-58	18,814
N00024-85-C-2036	Bath Iron Works	CG 60/61	330,111
N00024-84-C-2046	Todd	TAVB-3/4	2,808,852
N00024-80-C-2080 and N00024-83-C-2070	Lockheed	LSD 41-44	285,000
N00024-83-C-2070	Lockheed	LSD-42	0
N00024-83-C-2070	Lockheed	LSD-43	40,000
N00024-87-C-4071	Wormald Fire Systems	Fire Systems Sets	45,791
			$9,611,910

Of the contracts cited above, all were awarded at or below the Navy's estimate with the exception of 80-C-2080 and 83-C-2070.

QUESTION: Has the Navy, in response to cost overruns on shipbuilding contracts, any plans to change the award process for shipbuilding?

ANSWER: Navy shipbuilding contracts are awarded in accordance with applicable law and regulations. The Navy does not plan to change its strategy for obtaining competition in awarding shipbuilding contracts.

QUESTIONS SUBMITTED BY THE HONORABLE NORMAN F. LENT, RANKING MINORITY MEMBER, SUBCOMMITTEE ON MERCHANT MARINE, TO THE DEPARTMENT OF THE NAVY; ALONG WITH ANSWERS FURNISHED BY THE DEPARTMENT OF THE NAVY

GEOGRAPHIC NEEDS

Mr. Lent: With regard to your testimony about maintaining a geographic distribution of Government shipyards, is there also an effort to establish a similar list of critical private shipyards -- also based on geographic needs? It would help Congress to determine legislative and budget priorities if we knew what the Navy's needs were. It is difficult to legislate effectively if we do not know whether the Navy needs 100 private shipyards or 10.

Admiral Horne: NAVSEA is not aware of Navy plans to establish a list of critical private shipyards by geographic locations.

The Navy is in the process of refining mobilization requirements from which we can determine the number of private shipyards needed to support mobilization. This data, when complete, will be analyzed along with the reports generated by the President's Commission on Merchant Marine and Defense to establish our industrial resource requirements.

MSC CHARTERS

Mr. Lent: Does the Navy support any legislative proposal to bring about more economical tanker charter rates by lengthening the MSC charters of U.S.-built tankers?

Admiral Horne: In general, the Navy has been supportive of previous legislative proposals aimed at strengthening the U.S. tanker industry. There is, however, no proposal in the President's Budget that would lengthen tanker charter periods.

SUSTAINED CONSTRUCTION RATE

Mr. Lent: How many U.S. shipyards will be used for the sustained construction rate of 20 ships per year for the maintenance of the 600-ship Navy?

Admiral Horne: The number of U.S. shipyards used to sustain the construction rate of 20 ships per year will depend on the mix of ships to be acquired and on the results of competition for those ships. Currently, 17 yards are constructing Navy ships. We could see this number continue indefinitely or there could be as few as six to eight yards, with all nuclear work going specifically to either General Dynamics, Electric Boat Division, or Newport News Shipbuilding and Drydock Company.

CONTINGENCY PLANS

Mr. Lent: Does the Navy have any long-range contingency plans for ship construction and maintenance in light of the downward trend of private shipyards? Will the Government shipyards alone be adequate to meet all the Navy's needs?

Admiral Horne: The Navy continually evaluates the projected capabilities of the existing and anticipated participation of private shipyards to execute both near-term and long-range ship construction requirements. At this time, the industrial base is considered adequate to satisfy projected Navy ship construction requirements in lieu of the fact that no domestic commercial ship construction is expected to compete for declining resources for the next several years.

Government shipyards alone will not be adequate to meet all the Navy's needs.

MOBILIZATION CORE

Mr. Lent: In the prepared statement of December 8, 1987, you say that "we must maintain an appropriate mobilization core." How does the Navy propose to do that?

Admiral Horne: The Navy maintains a mobilization core by executing its posture plan in support of the maritime strategy. Chief of Naval Operations memo 4800 Ser 402F/5U395978 of 28 October 1985 promulgates Navy policy for conduct of Production Base Analysis for Industrial Preparedness Planning in accordance with DoDINST 4005.31

NAVSEA's posture planning goal is to maintain an industrial base (government and commercial) that will satisfy the depot maintenance and new construction requirements of peacetime workload and mobilization or national defense emergencies. We believe it is essential for Navy planning for both peacetime and mobilization to also recognize the requirements of other services and government agencies. We work toward this goal by complying with CNO Strategic and operational requirements (OPNAVINST 3050.22). Specifically, NAVSEA maintains two Naval shipyards on each coast capable of repairing aircraft carriers; one Naval shipyard on each coast capable of repairing surface nuclear ships; three Naval shipyards on each coast capable of overhauling nuclear submarines; three Naval shipyards on each coast capable of installing, checking out and repairing current state-of-the-art electronics, missile and combat weapon systems; and maintains Pearl Harbor Naval Shipyard capable of overhauling all ship types homeported in Hawaii. These capabilities are maintained to support readiness requirements for Naval shipyards which include (1) battle damage repairs, (2) voyage/emergent repairs, (3) necessary scheduled availabilities, (4) activations and conversions, and (5) stock system support.

In addition, mobilization priority requirements for private shipyards are (1) activations and conversions, (2) battle damage repairs and (3) all Navy and commercial new construction.

Periodic studies, such as NAVSEA's in-process Production Base Analysis, are conducted to identify changes in demographics, work complexity and skill requirements so that the conditions may be integrated into mobilization planning.

Effective workloading of the shipwork industry to maintain readiness and mobilization capacity and capability is a key consideration. Use of a decision logic approved by the Secretary of the Navy (SECNAVINST 4860.42C) is part of our effort in this area, providing a decision tree logic process for all ship depot level availability assignments.

These decision logics regulate the assignment of workloads to ensure adequate peacetime readiness and combat sustainability of operating forces, efficient use of available resources and maximum economies in maintenance operations.

Ship depot level availability assignments are generally based on categories of ship complexity. The most complex ships (nuclear ships, aircraft carriers and cruisers) are primarily assigned to Naval shipyards. Assignments are also made to qualified private shipyards. Moderately complex ships such as destroyer types may be assigned to either Naval shipyards or qualified private shipyards, while the non-complex ships such as support ships and small amphibious types are normally assigned to private shipyards. Some ship availabilities of all complexities are competed each year. Ships assigned to the private sector are competed in accordance with applicable laws and regulations. Naval shipyards compete against each other and also against the private shipyards for both short- and long- term depot level availabilities.

A major requirement that must be met by the Navy is that at least 30 percent of annually appropriated ship maintenance dollars must be spent in private shipyards.

NAVSEA is postured to accomplish its peacetime and mobilization workload requirements. This process is being used as a viable part of the Navy's overall management philosophy "to size facilities to be efficient in peacetime and capable of meeting wartime requirements." During the transition from peacetime to mobilization, hiring plans, utilization of secondary skills, changes in workload mixes and activation of reserve units provide added insurance of meeting mobilization requirements.

QUESTIONS SUBMITTED BY THE HONORABLE HELEN D. BENTLEY, MEMBER, SUBCOMMITTEE ON MERCHANT MARINE, TO THE DEPARTMENT OF THE NAVY; ALONG WITH ANSWERS FURNISHED BY THE DEPARTMENT OF THE NAVY

FOREIGN SUPPLIERS

Mrs. Bentley: Does the Navy subject foreign suppliers of ship components and systems to the same quality standards as U.S. firms? Can you provide one or two examples?

Admiral Horne: Yes. We impose quality/technical requirements on the shipbuilders, and equipment vendors who then purchase equipment to those requirements regardless of the source they select. The FFG-7 Class Fin Stabilizers, purchased from Brown Brothers Co., Ltd., Edinburgh, Scotland were competed between Sperry Marine Systems, Charlottesville, Virginia, and Brown Brothers, using the same technical specifications and corresponding quality standards.

Mrs. Bentley: Is DoD directed by the State Department, or elsewhere in the Executive Branch, to use foreign suppliers of equipment intended for use on Navy ships? If "No," then why is there so much use of foreign suppliers? Is price the overriding factor in selecting suppliers of ship components?

Admiral Horne: Price is only one of many reasons for foreign procurement. Technical considerations, lack of domestic capability, product quality, and schedule constraints are some of the other key criteria.

Mrs. Bentley: Do you acknowledge that some of the most critical components of Navy vessels, including propulsion systems and precision bearings, just to name two, must be purchased from foreign sources because there are no American suppliers?

Admiral Horne: We acknowledge that there are critical components which must be purchased from foreign suppliers because of a lack of U.S. sources. In the case of precision bearings, two U.S. sources have recently been developed and are now delivering bearings in all 131 sizes. Capacity appears adequate to meet Navy requirements. We know of no foreign propulsion components which could not be replaced by similar U.S. components if costs for components and ship modifications were no object.

SUPPLIERS OF COMPONENTS

Mrs. Bentley: Since the Navy has established a basic policy to contract with certain shipyards for the construction of specific combatant vessels in order to maintain mobilization capabilities, then why hasn't the Navy established a similar practice with American suppliers of important components?

Admiral Horne: The Navy has, where appropriate, required prime contractors and their sub-contractors to procure selected components from vendors to maintain mobilization capabilities. Anchor chain, mooring chain, critical metals, ship shafting, and hardened and ground gears are some examples of items restricted to key domestic and U.S. sources.

However, all Navy ship construction, excluding our aircraft carriers, are competed. It is the business decision of the individual shipyards to bid on specific ship programs. It is not Navy policy to contract with certain shipyards for specific vessels.

Mrs. Bentley: Are you confident foreign suppliers of components for the Navy will make these components readily available to the United States should a national emergency arise?

Admiral Horne: We believe foreign sourced components could be less readily available to the United States should a national emergency arise.

AMERICAN SOURCES

Mrs. Bentley: If access to all or most current foreign suppliers were suddenly denied to the Navy, would there be sufficient American sources for Navy components? If "No," how much lead time would be required to rebuild the industrial base to satisfy Navy needs during a surge mobilization?

Admiral Horne: We are unable to determine the impact of the loss of all or most foreign suppliers. The priorities and requirements of other services and government agencies are unknown. Further, the extent of U.S. reliance on foreign components at the sub-tier vendors level, and the impact of the loss of foreign sources for machine tools and parts of Navy equipment suppliers, are not clear.

FOREIGN SOURCES

Mrs. Bentley: Are any components for Navy vessels, regardless of their level of importance, obtained from suppliers from Soviet Bloc or Warsaw Pact countries? If "Yes," give examples.

Admiral Horne: We are not aware of any Soviet Bloc or Warsaw Pact components for U.S. Naval vessels.

CONTRACTING POLICIES

Mrs. Bentley: Have the Navy's current contracting policies and practices created an adversarial relationship with the maritime industry?

Admiral Horne: Navy contracting policy and practices are designed to maintain the maritime industrial base and, through the competitive process, obtain quality ship construction/repairs at the least cost to the taxpayer. Effective use of the Competition in Contracting Act (CICA) of 1984 has resulted in substantial savings to the taxpayer and also provided expanded opportunities for shipbuilding and ship repair firms for work that otherwise might have remained sole source. Contracting policies and practices in the past 4 years, rather than fostering an adversarial relationship with the maritime industry, have created an atmosphere of expanded opportunity.

MOBILIZATION POLICY

Mrs. Bentley: Does the Navy have a policy and implementing instructions that define public shipyard mobilization requirements and capabilities? For private shipyards?

Admiral Horne: The Navy maintains a mobilization core by executing its posture plan in support of the maritime strategy. Chief of Naval Operations memo 4800 Ser 402F/5U395978 of 28 October 1985 promulgates Navy policy for conduct of Production Base Analysis for Industrial Preparedness Planning in accordance with DoDINST 4005.31.

NAVSEA's posture planning goal is the implementation of DoD policy to maintain an industrial base (government and commercial) that will satisfy the depot maintenance and new construction requirements of peacetime workload and mobilization or national defense emergencies. We believe it is essential for Navy planning for both peacetime and mobilization to recognize the requirements of other services and government agencies. We work toward this goal by complying with CNO Strategic and Operational Requirements (OPNAVINST 3050.22). Specifically, NAVSEA maintains two Naval shipyards on each coast capable of repairing aircraft carriers; one Naval shipyard on each coast capable of repairing surface nuclear ships; three Naval shipyards on each coast capable of overhauling nuclear submarines; three Naval shipyards on each coast capable of installing, checking out and repairing current state-of-the-art electronics, missile and combat weapon systems; and maintains Pearl Harbor Naval Shipyard capable of overhauling all ship types homeported in Hawaii. These capabilities are maintained to support readiness requirements for Naval shipyards which include (1) battle damage repairs, (2) voyage/emergent repairs, (3) necessary scheduled availabilities, (4) activations and conversions, and (5) stock system support.

In addition, mobilization priority requirements for private shipyards are (1) activations and conversions, (2) battle damage repairs and (3) all Navy and commercial new construction.

Periodic studies, such as NAVSEA's in-process Production Base Analysis, are conducted to identify changes in demographics, work complexity, and skill requirements so that the conditions may be integrated into mobilization planning.

Effective workloading of the shipwork industry to maintain readiness and mobilization capacity and capability is a key consideration. Use of a decision logic approved by the Secretary of the Navy (SECNAVINST 4860.42C) is part of our effort in this area, providing a decision tree logic process for all ship depot level availability assignments.

These decision logics regulate the assignment of workloads to ensure adequate peacetime readiness and combat sustainability of operating forces, efficient use of available resources, and maximum economies in maintenance operations.

Ship depot level availability assignments are generally based on categories of ship complexity. The most complex ships (nuclear ships, aircraft carriers and cruisers) are primarily assigned to Naval shipyards. Assignments are also made to qualified private shipyards. Moderately complex ships such as destroyer types may be assigned to either Naval shipyards or qualified private shipyards, while the non-complex ships such as support ships and small amphibious types are normally assigned to private shipyards. Ships assigned to the private sector are competed in accordance with applicable regulations. Some ship availabilities of all complexities are competed each year. Naval shipyards compete against each other and also against the private shipyards for both short- and long- term depot level availabilities.

A major requirement that must be met by the Navy is that at least 30 percent of annually appropriated ship maintenance dollars must be spent in private shipyards.

NAVY SHIPYARDS VERSUS SMALL REPAIR FIRMS

Mrs. Bentley: Would you comment on the Navy's policy that requires major shipyards (that represent a significant investment in plant facilities, drydocks, engineering and management talent, etc.) to compete with much smaller repair firms that rent space on a pier to conduct their operations?

Admiral Horne: While the Navy does not have a specific policy which requires major shipyards to compete with smaller repair firms, a number of factors have led to that situation. First, the Navy's policy for bidding ship repair, overhaul, conversion and new construction solicitations is consistent with the Competition in Contracting Act (CICA). The CICA promotes free and open competition, to the extent practical, for all qualified sources of goods or services to obtain the most reasonable price. The Navy solicits its procurements in accordance with the Federal Acquisition Regulations (FAR) and this mandate.

Second, in recent years the Navy's ship maintenance strategy has changed from large overhauls to more frequent, smaller availabilities. The increasing number of short, surface ship availabilities with relatively small work packages has increased the opportunities for smaller firms to participate in Navy ship repair work, thus enabling these smaller firms to compete with the more heavily capitalized private yards.

This change in award policy has allowed many small shipyards with less capital investment and lower overhead costs to win repair work at the expense of larger, more heavily capitalized high over-head shipyards.

The Navy desires to support those firms which have invested in the managerial, technical and facilities capabilities required to conduct Navy repair work and new construction at the lowest cost and at the required quality level; these firms are a vital segment of the defense industrial base.

WEST COAST MOBILIZATION

Mrs. Bentley: Is there concern about the loss of major shipyards, such as Todd and Lockheed, as well as the loss of skilled manpower on the West Coast? If there is a concern in this region of the country, what plans does the Navy have to maintain, if not bolster, West Coast mobilization capabilities?

Admiral Horne: The Navy is concerned about the continuing overall decline in the number and types of shipyards in this nation. However, the Navy does not have specific geographic requirements for shipyards capable of performing new construction of Navy ships. Adequate ship maintenance capabilities are expected to continue to be available on the West Coast.

FOREIGN WORKERS

Mrs. Bentley: Explain why the Navy had to bring Japanese and Filipino shipyard workers to the United States to work on Navy projects? How much were each of these foreign workers paid, including bonuses and incentives, compared to American workers employed to perform similar tasks? Give a line item report on the cost of this program, including but not limited to the transportation and billeting of these foreign workers.

Admiral Horne: Philadelphia and Long Beach Naval Shipyards had heavy short-term workloads in specific trades and were unsuccessful in recruiting the necessary temporary skilled workers from local labor sources. There were no excess personnel in other stateside shipyards who could be borrowed. Two months were spent in attempting to acquire labor through advertisements in local newspapers, requests to borrow from other Naval shipyards, and flyers distributed to the shipyard workforce. All efforts were coordinated with unemployment agencies and assistance was requested from the Metal Trades Council. All of these efforts fell short of the manning requirements.

LONG BEACH NAVAL SHIPYARD:

The rationale of using workers from the U.S. Navy Repair Facility in Yokosuka, Japan, for 7 to 8 weeks in Long Beach Naval Shipyard, was twofold. First, it provided skilled workers to assist the shipyard in critically overloaded areas, and secondly, specialized training for the Japanese Nationals to better equip them to perform emergent repairs on Navy ships in the Western Pacific.

The Long Beach Naval Shipyard paid the Government of Japan $12.01 per hour for each of those workers, and no bonuses or incentives were paid. It is unknown, however, how much the Government of Japan actually paid the workers. For comparison purposes, the shipyard corporate rate for those trades and number of hours equates to $16.61 per hour. The shipyard rate of $12.01 per hour paid to Japan includes acceleration.

Line Items for this effort:

$ 36,816	Air Fare
37,519	Per diem (including temp quarters rental)
9,992	TDY salaries (in transit)
29,977	Salaries while working
3,108	Van rental
1,000	Shipyard transportation
2,500	Miscellaneous expenses
$120,912	ACTUAL COSTS INCURRED BY LBNSY

PHILADELPHIA NAVAL SHIPYARD

Philadelphia Naval Shipyard experienced a severe shortage of electricians and electronics workers and was unable to handle the heavy ship overload during this time period. The shipyard had actively recruited for skilled workers with display advertisements in local newspapers; however, this recruitment effort was only minimally successful because the shipyard could only offer temporary employment and the private sector's hourly rate for these skilled workers was considerably higher than the approved pay scale for the shipyard. Philadelphia also requested assistance from the other Naval shipyards, but this effort resulted in only eight electronic mechanics from Pearl Harbor Naval Shipyard being temporarily assigned to Philadelphia Naval Shipyard.

Philadelphia Naval Shipyard paid the workers from Subic Bay and Yokosuka two different hourly wages; Subic Bay workers were paid $3.35 an hour and Yokosuka workers were paid $11.00 an hour. The actual cost for utilizing these workers at Philadelphia will not be known until the billings from the Ship Repair Facilities are received; however, the total cost to date is $474,807. The cost Breakdown is as follows:

Labor	$207,293.00
Per Diem	155,792.00
Travel	111,500.00
Miscellaneous Expenses	222.00
Actual Costs to Date	$474,807.00

STATEMENT OF BILL W. THURMAN, DEPUTY DIRECTOR FOR PLANNING AND REPORTING, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION, UNITED STATES GENERAL ACCOUNTING OFFICE, BEFORE THE SUBCOMMITTEE ON MERCHANT MARINE ON THE REDUCTION IN U.S. SHIPBUILDING AND SHIP REPAIR CAPABILITY -- DECEMBER 8, 1987

I am pleased to be here today to discuss our report on selected ship construction contracts.[1] Our report was prepared at the request of the Chairman, Subcommittee on Defense, House Committee on Appropriations.

We reviewed selected shipbuilding contracts to determine: (1) whether the contracts can be executed within the funding appropriated; (2) whether the awards could result in future claims against the Government; (3) actions the Navy is taking to address current and anticipated claims; and (4) whether the Navy's Supervisor of Shipbuilding, Conversion, and Repair (SUPSHIP) activities is providing effective oversight of the contracts. In particular, we reviewed 22 fixed-price incentive contracts, which were competitively-awarded over the past few years. The contracts covered 69 vessels involving 9 combatant and noncombatant ship programs at 10 private shipyards.

ADEQUACY OF FUNDING

Our review showed that the Navy policy of competing ship construction contracts has generally resulted in lower and declining contract prices. However, at the completion of our work in July 1987, the Navy was projecting cost overruns totalling about $1.4 billion, or about 16 percent over the target costs, for 19 of the 22 contracts. Some of these contracts are also experiencing schedule slippages and delivery delays.

On fixed-price incentive contracts, the Navy shares a portion (generally 50 percent) of overruns exceeding the target costs, up to a ceiling price. If final costs come in at the current estimates, the Navy will have to fund about $706 million for overruns. The Navy, in most cases, has sufficient program account funds to cover the Navy portion of the cost overruns. For a few programs, the Navy anticipates submitting reprogramming requests to cover its share of estimated overruns.

Costs above the ceiling price are borne entirely by the contractor. The estimated completion costs for many of the 22 contracts are close to, at, or above the ceiling price. Nine contracts had estimates of at least 90 percent of ceiling, and four had projected costs at or above the ceiling.

In April 1987 we testified before the Subcommittee on Defense, House Committee on Appropriations and reported that 5 of the 22 contracts were underrunning target costs by about $60 million, apparently because anticipated production efficiencies were being realized and construction costs were being reduced. By July 1987, however, this had changed and only 3 contracts were projected to underrun the target costs by about $26 million. In these types of cases, the savings are shared equally by the Navy and shipbuilders.

The causes for the projected overruns are many and varied. On some contracts, shipbuilders are experiencing labor productivity problems and shipyard inefficiencies; on others, the shipyards appear to have underestimated the complexities of construction. Some contracts have experienced a large amount of design changes and are being affected by external problems such as late Government furnished equipment and data.

It appears, however, that the overruns can be primarily attributed to optimistic bidding fostered by a competitive environment, anticipated production efficiencies which have not materialized and unrealistically low labor hour estimates.

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[1] Navy Contracting: Cost Overruns and Claims Potential on Navy Shipbuilding Contracts, October 16, 1987, GAO/NSIAD-88-15.

Our analysis of the contracts showed that some proposed prices were identified by the Navy, at the time of the award, to be optimistic. The proposed prices were below the government estimates, and the Navy believed they presented a risk of cost overruns.

We interviewed five shipbuilders to obtain their views on the business environment. There was a general agreement that the industry is currently competing in a "low ball" or close to a marginal profit environment on Navy ship construction contracts. Although the shipbuilders supported the competitive process and fixed-price contracts for follow-on ships, they were concerned about the long range effects of the Navy's emphasis on price competition on the weak shipbuilding industry. In their view, the competitive environment forces shipbuilders to bid aggressively for the limited work, because the lowest price is the Navy's principal determining factor for awarding contracts.

According to the shipbuilders, the Navy has not put adequate weight on price realism and the shipyards' ability to meet the price. They believe this leads to low bids with a likelihood for overruns.

I should note that there is nothing to prevent an offeror from reducing its prices for competitive purposes. As long as the proposal is technically acceptable, and the contractor is determined to be responsible, the contract may be awarded to that offeror. The contracting officer must, however, assure that change orders or follow-on procurements are not used to recover amounts of below-cost bids.

Our analysis showed that, although price was the highest-weighted factor in all 22 procurements, the Navy in its evaluation of the offers, did consider other technical and management factors. Where necessary, pre-award surveys were performed and, in all cases, a determination of contractor responsibility was made.

CLAIMS AGAINST THE GOVERNMENT

Where there are significant contract cost overruns there is an increased likelihood of contractor claims against the government or Requests for Equitable Adjustment (REAs). An REA is a request for monetary payment, extension of the delivery schedule, or both, which is not in dispute at the time the Government receives it. Whenever a dispute cannot be settled by an agreement, the contractor may file a claim relating to the dispute. As of July 1987, contractors were attempting to recover, or anticipated submitting REAs or claims for 8 of the 19 contracts projecting cost overruns.

For example, Bath Iron Works (BIW) submitted an REA in November 1986 on three CG-47 Aegis cruiser contracts to cover cost overruns. The REA stated that BIW's and the Navy's projected cost to the Aegis cruiser program has changed for many reasons including: government changes, delays, disruptions, a shipyard strike, and shipyard performance problems.

As a result of these and other variances, BIW stated that both parties needed to re-establish cost, schedule and technical baselines. The REA assigned responsibilities for the cost increases and computed a proposed contract adjustment of about $100 million. In December 1986, BIW responded to a Navy request and provided additional supporting data to facilitate the Navy's analysis of the REA. In May 1987, BIW submitted a revised REA that completely replaced the November 1986 submission. The contractor requested an adjustment of about $134 million. The Navy has recently increased the contracts by $37.5 million.

The Naval Sea System Command (NAVSEA) has policies and procedures for preventing, avoiding, and reducing contractor claims for price increases on ship contracts. These measures are required to be implemented at the SUPSHIP organizations that interface with the shipbuilder where many of the incidents resulting in claims occur. The SUPSHIP activities we visited have implemented claims avoidance or prevention programs. An important aspect of these programs is maintaining a documented record of significant events during each contract: delivery schedule changes or problems, differences in interpretation of contract provisions, changes in the method or sequence of work, contractor errors, and non-compliance with contract terms.

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In summary, Mr. Chairman, our work indicates that over the past few years, the U.S. shipbuilding industry, faced with a weak and declining commercial market, has been intensely competing for limited Navy ship construction work. While highly-competitive bidding on Navy contracts has produced favorable contract prices it is contributing to cost overruns that could present future problems to the shipbuilders and the Navy.

Mr. Chairman, that concludes my statement. I will be pleased to answer any questions you may have.

QUESTIONS SUBMITTED BY THE HONORABLE MIKE LOWRY, MEMBER, COMMITTEE ON MERCHANT MARINE AND FISHERIES, TO THE GENERAL ACCOUNTING OFFICE; ALONG WITH ANSWERS FURNSHED BY GAO, 19 FEBRUARY 1988

Question. During the Navy testimony before the Seapower Subcommittee of the House Armed Services Committee on March 5, 1987, Vice Admiral William H. Rowden, U.S. Commander of Naval Sea Systems Command stated: "We have no contract claims for Navy shipbuilding programs at this time".

During your study did you find that the Navy experienced contract claims at any time in February 1987?

Answer. We do not have the data showing whether claims were submitted in February 1987, however, we did examine the Naval Sea Systems Command Claims Status Reports dated January 1, 1987 and March 31, 1987. The January report listed 10 claims relating to ship construction with a value of about $100.9 million. The March 31, 1987, report showed that the number of claims had increased to 15 with a value of about $106.6 million.

Question. I understand that 17 of the 22 contracts you examined had significant cost overruns. Do you expect this trend to continue?

Answer. We are not certain whether that trend will continue. However, we do intend to continue to monitor costs trends for Navy ship construction contracts, since the extent of cost overruns experienced to date are a reason for concern.

Question. Is optimistic bidding playing a part in the cost overruns?

Answer. Yes. As we stated in our report, successful contract offers included overly optimistic learning curves, aggressive labor-hour reductions, and optimistic estimating. When the contractor's expectations are not subsequently realized, a significant cost overrun can result.

Question. Has the Navy changed its award process in response to these overruns?

Answer. We are not aware of any changes that have been made in the Navy's source selection process for shipbuilding awards that specifically address or affect the cost overrun situation.

Question. Did the cost overruns affect vessel delivery schedules?

Answer. In conducting our work we did not focus specifically on this issue. However, as of April 1987, schedule slippages and delays were anticipated on six contracts that were projecting cost overruns. A total of 12 ships in the cruiser (CG), destroyer (DDG), and attack submarine (SSN) classes were involved in the slippages and delays.

Question. Is there a relationship between claims against the government and low contract awards?

Answer. Past experience suggests that when shipbuilders encounter severe financial difficulties under Navy contracts one of the results is large claims against the government. We believe the developing trends associated with cost overruns and claims on Navy contracts need to be carefully monitored.

Question. When you say some shipbuilders are experiencing labor productivity problems and shipyard inefficiencies which contribute to cost overruns, what do you mean?

Answer. Our analysis of Navy studies and assessments of the causes of productivity problems and inefficiencies at certain shipyards identified a number of factors contributing to cost overruns. Some of the factors included:

-- changes in shipyard employee moral and/or skill composition,

-- unresolved labor issues,

-- effects of a strike,

-- difficulties in transitioning to more complex ship construction,

-- reductions in shipyard workforce not keeping pace with reductions in workload, and

-- shortages of skilled labor.

STATEMENT OF DR. ALLAN W. CAMERON, EXECUTIVE DIRECTOR OF THE COMMISSION ON MERCHANT MARINE AND DEFENSE, BEFORE THE SUBCOMMITTEE ON MERCHANT MARINE OF THE HOUSE MERCHANT MARINE FISHERIES COMMITTEE ON THE REDUCTION IN U.S. SHIPBUILDING AND SHIP REPAIR CAPABILITY.

DECEMBER 8, 1987

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE ON MERCHANT MARINE, MY NAME IS ALLAN CAMERON. I AM THE EXECUTIVE DIRECTOR OF THE COMMISSION ON MERCHANT MARINE AND DEFENSE. IT IS A PLEASURE FOR ME TO BE HERE THIS AFTERNOON AT THE DIRECTION OF THE COMMISSIONERS TO PRESENT THE FINDINGS OF THE COMMISSION ON THE CURRENT AND PROJECTED CAPABILITY OF THE UNITED STATES SHIPBUILDING AND SHIP REPAIR INDUSTRIES.

FIRST, I WOULD LIKE TO PRESENT SOME BACKGROUND ON THE COMMISSION.

THE COMMISSION WAS ESTABLISHED BY PUBLIC LAW 98-525 OF OCTOBER 19, 1984, AS AMENDED. THE LAW STATES:

> THE COMMISSION SHALL STUDY PROBLEMS RELATING TO TRANSPORTATION OF CARGO AND PERSONNEL FOR NATIONAL DEFENSE PURPOSES IN TIME OF WAR OR NATIONAL EMERGENCY, THE CAPABILITY OF THE UNITED STATES MERCHANT MARINE TO MEET THE NEED FOR SUCH TRANSPORTATION AND THE ADEQUACY OF THE SHIPBUILDING MOBILIZATION BASE OF THE UNITED STATES TO MEET THE NEEDS OF NAVAL AND MERCHANT SHIP CONSTRUCTION IN TIME OF WAR OR NATIONAL EMERGENCY. BASED ON THE RESULTS OF THE STUDY, THE COMMISSION SHALL MAKE SUCH SPECIFIC RECOMMENDATIONS, INCLUDING RECOMMENDATIONS FOR LEGISLATIVE ACTION, ACTION BY THE EXECUTIVE BRANCH, AND ACTION BY THE PRIVATE SECTOR, AS THE COMMISSION CONSIDERS APPROPRIATE TO FOSTER AND MAINTAIN A UNITED STATES MERCHANT MARINE CAPABLE OF MEETING NATIONAL SECURITY REQUIREMENTS.

THE COMMISSION WAS CONSTITUTED ON DECEMBER 5, 1986, WITH THE SWEARING IN OF THE FIVE MEMBERS APPOINTED BY THE PRESIDENT WITH THE ADVICE AND CONSENT OF THE SENATE: MR. EDWARD E. CARLSON; MR. WILLIAM HAGGETT; ADMIRAL JAMES L. HOLLOWAY, III, USN (RET.); MR. JOSEPH SEWALL; AND MR. SHANNON J. WALL. MR. JOHN GAUGHAN, ADMINISTRATOR OF THE MARITIME ADMINISTRATION, WAS SWORN IN AS A MEMBER EX OFFICIO. ON JANUARY 5, 1987, FORMER SENATOR JEREMIAH DENTON OF ALABAMA WAS SWORN IN AS THE DELEGATE OF THE SECRETARY OF THE NAVY TO BE THE CHAIRMAN. I WAS SWORN IN AS EXECUTIVE DIRECTOR ON THAT SAME DAY.

THE LAW REQUIRES THE COMMISSION TO PREPARE FOUR REPORTS, THE FIRST OF WHICH HAS ALREADY BEEN SUBMITTED. BASED ON THE DATE OF CONSTITUTION OF THE COMMISSION, THE REQUIRED REPORT DATES ARE AS FOLLOWS:

FINDINGS OF FACT AND CONCLUSIONS:	SEPTEMBER 1987
RECOMMENDATIONS:	DECEMBER 1987
FINDINGS OF FACT AND CONCLUSIONS:	SEPTEMBER 1988
RECOMMENDATIONS:	DECEMBER 1988

BETWEEN JANUARY AND NOVEMBER 1987, THE COMMISSION HELD ELEVEN MULTI-DAY MEETINGS. THE COMMISSIONERS HAVE CONDUCTED SIX PUBLIC HEARINGS, AND THE PROCEEDINGS OF THESE HEARINGS WERE PUBLISHED LAST MONTH.

FEBRUARY	TANKER AND DRY BULK CARRIERS
MARCH	LINER OPERATORS
APRIL	MARITIME LABOR
MAY	SHIP CONSTRUCTION AND REPAIR
JUNE	SHIPPERS OF GOODS
JULY	SUPPLIER INDUSTRIES FOR SHIP CONSTRUCTION AND REPAIR

YOU WILL NOTE THAT ONE HEARING WAS ON THE SHIP CONSTRUCTION AND REPAIR INDUSTRY, AND THAT ANOTHER WAS ON THE SUPPLIER INDUSTRIES, THE "INDUSTRIAL BASE" FOR THE MARITIME INDUSTRIES IN THE UNITED STATES.

MR. CHAIRMAN, ON OCTOBER 19, 1987, THE COMMISSIONERS PERSONALLY PRESENTED THEIR FIRST REPORT, "FINDINGS OF FACT AND CONCLUSIONS," TO PRESIDENT REAGAN AT THE WHITE HOUSE. THE REPORT WAS ALSO PRESENTED FORMALLY TO THE CONGRESS, AND COPIES WERE PROVIDED TO EACH MEMBER.

THE REPORT BEGINS WITH THE FOLLOWING GENERAL CONCLUSIONS:

- "THE COMMISSION HAS FOUND CLEAR AND GROWING DANGER TO THE NATIONAL SECURITY IN THE DETERIORATING CONDITION OF AMERICA'S MARITIME INDUSTRIES. THE UNITED STATES CANNOT CONSIDER ITS OWN INTERESTS OR FREEDOMS SECURE, MUCH LESS RETAIN A POSITION OF LEADERSHIP IN THE FREE WORLD, WITHOUT REVERSING THE DECLINE OF THE MARITIME INDUSTRIES OF THIS NATION, WHICH WOULD DEPEND SO HEAVILY IN A PROTRACTED WAR UPON ADEQUATE USE OF OCEANS FOR ITS MILITARY DEFENSE AND FOR ITS ECONOMIC SURVIVAL.
- "THE COMMISSION ADDRESSED ITSELF TO THE DEFENSE ASPECTS OF THE MERCHANT MARINE INDUSTRY, BUT IN ITS STUDIES AND ANALYSES HAS COME UNAVOIDABLY TO RECOGNIZE THAT, ALTHOUGH THE MARITIME DEFENSE IMPLICATIONS ARE URGENT, THE DECLINE OF THE MARITIME INDUSTRIES IS PART OF A MORE GENERAL PROBLEM AS THE UNITED STATES SHIFTS INCREASINGLY FROM AN INDUSTRIAL TOWARD A SERVICES BASED ECONOMY. THE COMMISSION CONCLUDES THAT THE UNITED STATES GOVERNMENT HAS NOT YET ADEQUATELY ASSESSED THE DEVELOPING AND MASSIVE DEFENSE IMPLICATIONS OF THE SHIFT.
- "THE COMMISSIONERS, AT THIS POINT, UNANIMOUSLY AGREE THAT MAJOR GOVERNMENTAL EFFORT IS URGENTLY REQUIRED, INDEED OVERDUE, TO REVISE OUR NATIONAL OBJECTIVES, POLICIES, AND COMMITMENTS IN ORDER TO REVERSE THE DECLINE OF THE MARITIME INDUSTRIES."
- "THERE IS TODAY INSUFFICIENT STRATEGIC SEALIFT, BOTH SHIPS AND TRAINED PERSONNEL, FOR THE UNITED STATES, USING ONLY ITS OWN RESOURCES AS REQUIRED BY DEFENSE PLANNING ASSUMPTIONS, TO EXECUTE A MAJOR DEPLOYMENT IN A CONTINGENCY OPERATION IN A SINGLE DISTANT THEATER SUCH AS SOUTHWEST ASIA. WITHOUT DECISIVE ACTION, THE SITUATION WILL WORSEN SUBSTANTIALLY BY THE YEAR 2000.

THE COMMISSION HAS ASSESSED THE PERFORMANCE OF THE UNITED STATES MARITIME INDUSTRIES IN CONSIDERABLE DEPTH, AND IT IS CONVINCED OF THE ABSOLUTE NEED TO REVERSE THE TRENDS THAT HAVE MADE IT VIRTUALLY IMPOSSIBLE FOR AMERICAN MARITIME INDUSTRIES FULLY TO MEET DEFENSE MOBILIZATION REQUIREMENTS. ALTHOUGH IT BELIEVES THAT RECENT TRENDS MUST BE QUICKLY REVERSED BY POSITIVE GOVERNMENT INTERVENTION AND ACTION, THE COMMISSION IS COGNIZANT OF THE FACT THAT AMERICAN SHIP OPERATORS, MARITIME LABOR, AND SHIPYARDS SHARE SOME OF THE RESPONSIBILITY FOR THE PROBLEMS THAT HAVE DEVELOPED IN THE INDUSTRY. THEY MUST BE ACTIVE PARTICIPANTS IN THE EFFORT FOR IMPROVED PERFORMANCE IN THE FUTURE.

THE COMMISSION HAS TAKEN A CRITICAL LOOK AT EACH MAJOR SEGMENT OF THE MARITIME INDUSTRIES AND AT THE ALLIED INDUSTRIES THAT SUPPLY THEM WITH MATERIAL. IT AGREES THAT SOME FAULT CAN BE FOUND WITH THE HISTORIC PERFORMANCE OF THE MARITIME INDUSTRIES. NONETHELESS, ALTHOUGH THE COMMISSION RECOGNIZES THAT MANY OF THE PROBLEMS OF THE MARITIME INDUSTRIES HAVE BEEN OF THEIR OWN MAKING, IT BELIEVES THAT GOVERNMENT POLICY HAS BEEN A FACTOR IN OUR NATION'S MARITIME DECLINE.

IN ANY EVENT, THE COMMISSION HAS BEEN IMPRESSED BY RECENT ADVANCES UNDERTAKEN BY THE MARITIME INDUSTRIES, WHICH HAVE ATTEMPTED TO COPE WITH PROBLEMS INHERITED FROM THE PAST AND TO BECOME MORE EFFICIENT AND COMPETITIVE. ALTHOUGH THE INNOVATIVE EFFORTS AND COST CONSCIOUSNESS SHOWN BY THE INDUSTRIES DURING THE LAST SEVERAL YEARS ARE LAUDABLE, THE COMMISSION IS CONVINCED THAT, EVEN UNDER THE BEST OF CIRCUMSTANCES, THE AMERICAN MERCHANT MARINE CANNOT COMPETE IN WORLD MARKETS WITHOUT GOVERNMENT SUPPORT. IN A WORLD MARITIME COMMUNITY WHERE BUSINESS IS INCREASINGLY MOVING TOWARD DEVELOPING NATIONS AND THE LOWEST LABOR COST, IT IS TOTALLY UNREALISTIC TO EXPECT AMERICANS TO REDUCE THEIR STANDARD OF LIVING TO THE DEGREE THAT WOULD BE NECESSARY TO PREVAIL IN HEAD-TO-HEAD COMPETITION BASED ONLY ON PRICE.

THE COMMISSION BELIEVES THAT SEALIFT IS ABSOLUTELY ESSENTIAL TO THE SUCCESS OF OUR MILITARY STRATEGY AND TO THE EXECUTION OF OUR MILITARY CONTINGENCY PLANS. THERE IS NO PLAN FOR ANY MAJOR OVERSEAS MILITARY OPERATIONS, WHETHER IT BE GENERAL WAR INVOLVING THE SOVIET UNION OR CONTINGENCY OPERATION IN SOME REMOTE CORNER OF THE GLOBE, THAT DOES NOT INVOLVE THE USE OF THE SEAS FOR PROJECTING AND SUSTAINING AMERICAN MILITARY FORCES.

BASED ON ITS STUDY AND ANALYSIS, THE COMMISSION HAS CONCLUDED THAT THERE IS NO MORE MILITARILY EFFICIENT, COST EFFECTIVE, AND RELIABLE WAY TO PROVIDE THE MAJORITY OF THE MILITARY SEALIFT REQUIREMENT NOW AND IN THE FUTURE THAN THROUGH AN ACTIVE UNITED STATES FLAG MERCHANT MARINE. THE SHIPS SHOULD BE MILITARILY USEFUL AND OPERATING, ENGAGED IN PEACETIME IN CARRYING COMMERCIAL CARGO, AND MANNED BY UNITED STATES CREWS.

THE U.S. MERCHANT MARINE TODAY

THE MARITIME INDUSTRIES HAVE BEEN IN A STATE OF DECLINE FOR MANY YEARS, BUT THE RATE OF DECLINE IS NOW INCREASING AT AN ALARMING RATE. SOME OF THE LARGEST SHIP OPERATORS, SHIPYARDS, AND SHIPYARD SUPPLIERS HAVE GONE OUT OF BUSINESS, AND MOST OF THOSE THAT REMAIN FACE SERIOUS FINANCIAL HARDSHIP. THE COMMISSION'S ANALYSIS SHOWS THAT, UNLESS ACTIONS ARE TAKEN TO REVERSE THE DOWNWARD TREND, THE NUMBER OF MERCHANT SHIPS AND SEAMEN WILL BE REDUCED BY ONE-HALF BY THE YEAR 2000. SIMILARLY, THE SHIPBUILDING AND REPAIR INDUSTRY WILL CONTINUE TO SHRINK AND WILL BE ALMOST TOTALLY DEPENDENT ON NAVY WORK FOR ITS VERY EXISTENCE.

THE OPERATING UNITED STATES FLAG MERCHANT MARINE HAS DECLINED FROM 2,114 ACTIVE SHIPS (OF OVER 1,000 GROSS REGISTERED TONS), TOTALING 23,651,000 DEADWEIGHT TONS IN JUNE 1947, TO ONLY 369 ACTIVE SHIPS, TOTALING 15,895,000 DEADWEIGHT TONS, UNDER BOTH PRIVATE AND GOVERNMENT OWNERSHIP IN JANUARY 1987. THE NUMBER OF INACTIVE SHIPS DECLINED FROM 1,582 (15,231,000 DEADWEIGHT TONS) IN 1947 TO 351 (8,562,000 DEADWEIGHT TONS) TODAY.

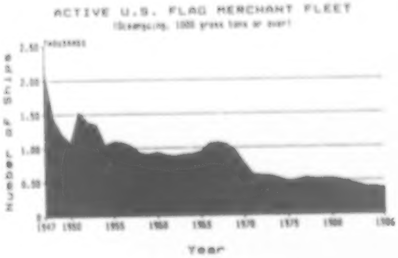

FIGURE 1

A MAJOR REASON FOR TODAY'S CRITICAL SITUATION LIES IN ECONOMIC FACTORS AFFECTING UNITED STATES SHIPS IN THE INTERNATIONAL TRADES. THE DECLINE OF THE MERCHANT MARINE HAS BEEN CONTINUOUS DURING THE LAST SEVERAL DECADES IN SPITE OF FEDERAL SUPPORT PROGRAMS, SUCH AS CONSTRUCTION DIFFERENTIAL SUBSIDY (CDS), OPERATING DIFFERENTIAL SUBSIDY (ODS), CAPITAL CONSTRUCTION FUNDS (CCF), TITLE XI GUARANTEES, AND RESERVATION OF 50% OR MORE OF GOVERNMENT-IMPELLED CARGOES FOR TRANSPORT IN UNITED STATES FLAG SHIPS.

ALTHOUGH THOSE PROGRAMS HAVE NOT BEEN SUFFICIENT TO REVERSE THE DOWNWARD TREND OF THE AMERICAN MERCHANT MARINE, AND HAVE NOT ALL BEEN CONTINUOUSLY OR CONSISTENTLY IMPLEMENTED, IT IS IMPORTANT TO UNDERSTAND THAT, COLLECTIVELY, THEY ARE PROBABLY RESPONSIBLE FOR THE FACT THAT THERE IS STILL A MERCHANT MARINE OPERATING IN THE INTERNATIONAL TRADES AT ALL.

MOST OF THE PROGRAMS, HOWEVER, HAVE TENDED TO BENEFIT THE LINER FLEET (GENERAL CARGO COMMON CARRIERS ON FIXED SCHEDULES), WHICH CURRENTLY IS THE HEALTHIEST SECTOR OF THE INDUSTRY, ALTHOUGH IT CARRIES LESS THAN 19% OF OUR FOREIGN LINER TRADE, DOWN FROM ABOUT 27% ONLY FIVE YEARS AGO. EVEN THE LINER COMPANIES, HOWEVER, HAVE BEEN SLIPPING BADLY DURING RECENT YEARS, DOWN FROM 18 MAJOR COMPANIES, EACH OPERATING FIVE OR MORE SHIPS, WITH A TOTAL OF 434 SHIPS IN 1970, TO ONLY 4 MAJOR COMPANIES, WITH A TOTAL OF 88 SHIPS OPERATING IN THE FOREIGN TRADES TODAY.

OF THE TOTAL CARGO IN THE LIQUID AND DRY BULK INTERNATIONAL TRADES, INCLUDING TRANSPORTATION OF PETROLEUM, UNITED STATES FLAG SHIPS CARRY ONLY A VERY SMALL PORTION OF THE TOTAL, AND MUCH OF THAT IS REQUIRED BY THE CARGO RESERVATION LAWS TO BE MOVED IN AMERICAN BOTTOMS.

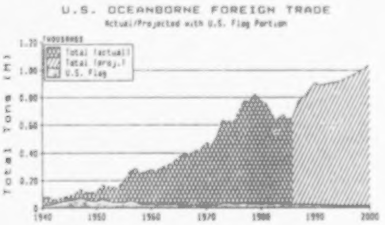

FIGURE 2

THE ACCELERATING RATE OF DOWNTURN IN THE ECONOMIC FORTUNES OF THE MERCHANT MARINE INDUSTRY HAS CAUSED GRAVE CONCERN ABOUT WHETHER AN AMERICAN MERCHANT MARINE, OPERATING IN THE INTERNATIONAL TRADES, CAN SURVIVE EXCEPT AS THE CARRIER OF THE SMALL AMOUNTS OF MILITARY AND GOVERNMENT-IMPELLED CARGO REQUIRED BY THE CARGO RESERVATION LAWS TO BE SHIPPED ON UNITED STATES FLAG SHIPS.

THERE WILL BE AMERICAN FLAG SHIPS OPERATING IN THE DOMESTIC TRADE AS LONG AS THE CABOTAGE LAWS DO NOT ALLOW FOREIGN SHIPS TO CARRY CARGO BETWEEN UNITED STATES PORTS. UNFORTUNATELY, DOMESTIC WATER-BORNE TRADE AND GOVERNMENT-IMPELLED CARGO CANNOT SUPPORT A MERCHANT MARINE OF THE SIZE AND CHARACTERISTICS NEEDED TO MEET OUR NATIONAL SECURITY REQUIREMENTS.

THE COMMISSION CONCLUDED THAT UNITED STATES GOVERNMENT DEPARTMENTS AND AGENCIES HAVE NOT SEEMED FULLY SUPPORTIVE OF THE UNITED STATES FLAG MERCHANT MARINE, AND SEVERAL POLICIES AND PRACTICES HAVE HAD HARMFUL EFFECTS ON THE AMERICAN MARITIME INDUSTRIES.

THE RELIANCE OF AMERICAN FLAG OPERATORS ON DEPARTMENT OF DEFENSE CARGO HAS BECOME SO DOMINANT THAT AT TIMES THE COMPETITION HAS BECOME DESTRUCTIVE, DRIVING DEPARTMENT OF DEFENSE RATES BELOW A FAIR *LEVEL OF COMPENSATION FOR THE COSTS* OF CARGO CARRIAGE; SHORT-TERM GOVERNMENT SAVINGS ARE OBTAINED ONLY AT LONG-TERM COSTS TO THE UNITED STATES FLAG OPERATORS.

THE COMMISSIONERS CONCLUDED THAT CONGRESS AND THE EXECUTIVE BRANCH HAVE ENACTED AND IMPLEMENTED PROCUREMENT POLICIES THAT HAVE EMPHASIZED BID PRICE RATHER THAN VALUE, WITH UNACCEPTABLY HARMFUL EFFECTS FOR BOTH THE MERCHANT MARINE AND THE SHIPBUILDING AND REPAIR INDUSTRIES IN THE FORM OF THE EROSION OF INDUSTRIAL CAPACITY AND CAPABILITY, SOME LOSSES IN OUR TRADITIONAL LEAD IN TECHNOLOGICAL AND SERVICE INNOVATION, AND GROWING DEPENDENCE ON FOREIGN SOURCES OF GOODS AND SERVICES.

WITHIN THE GOVERNMENT ITSELF, VARIOUS AGENCIES AT TIME HAVE ATTEMPTED, WITH VARYING LEVELS OF SUCCESS, TO IGNORE THE CARGO RESERVATION STATUTES IN ORDER TO SHIP GOVERNMENT-IMPELLED CARGOES ON FOREIGN FLAG SHIPS AT LOWER COST TO THEIR OWN BUDGETS. THE COMMISSIONERS CONCLUDED THAT CONTINUATION OF AND STRICT ADHERENCE TO EXISTING STATUTORY PROGRAMS TO RESERVE CARGO FOR UNITED STATES FLAG CARRIERS, INCLUDING THE MILITARY CARGO PREFERENCE ACT OF 1904, THE CARGO PREFERENCE ACT OF 1954, AND THE JONES ACT, ARE ESSENTIAL. HOWEVER IMPORTANT THOSE PROGRAMS ARE, RELIANCE ON THEM ALONE WILL NOT PROVIDE SUFFICIENT CARGO TO SUPPORT A UNITED STATES FLAG MERCHANT MARINE AND A SHIPBUILDING AND REPAIR INDUSTRY OF THE SIZE AND COMPOSITION NEEDED FOR NATIONAL DEFENSE.

AMERICAN SHIP OPERATORS, LIKE OTHER AMERICAN INDUSTRIES, ARE STILL FACED WITH A MULTITUDE OF FORMAL AND INFORMAL RESTRICTIONS EVEN WHEN FOREIGN MARKETS ARE DECLARED "OPEN."

EVEN WITH ADEQUATE LAWS ON THE BOOKS, THE UNITED STATES GOVERNMENT HAS NOT BEEN ABLE EFFECTIVELY TO COME TO THE AID OF AMERICAN CARRIERS WHO HAVE BEEN SUBJECTED TO UNFAIR FOREIGN PRACTICES. THE MECHANISM FOR RESPONDING TO COMPLAINTS IS SLOW AND CUMBERSOME, AND AMERICAN CARRIERS ARE AFRAID THAT OPEN COMPLAINTS MAY NOT BRING ABOUT EFFECTIVE ACTION BUT WILL INSTEAD SURELY PROVOKE RETALIATION FROM THE FOREIGN COUNTRIES INVOLVED. THE COMMISSION CONCLUDED THAT "FREE TRADE" IN REALITY DOES NOT EXIST TODAY BECAUSE OF THE PREVALENCE OF DISCRIMINATION AND PROTECTIONISM IN INTERNATIONAL COMMERCE, SOMETIMES INVOLVING OUR CLOSEST TRADING PARTNERS AND SOMETIMES IN VIOLATION OF THE SPIRIT AND LETTER OF EXISTING AGREEMENTS. THE UNITED STATES GOVERNMENT HAS NOT DONE AS MUCH AS IT COULD TO DEAL WITH THAT SITUATION BY EFFORTS TO PROVIDE AMERICAN FLAG SHIP OPERATORS WITH FREE ACCESS TO INTERNATIONAL MARKETS THROUGH ALL MEANS, INCLUDING INTERNATIONAL TRADE NEGOTIATIONS.

THE COMMISSIONERS ALSO EXPRESSED GREAT CONCERN ABOUT THE TRENDS IN THE SIZE AND COMPOSITION OF THE MERCHANT MARINE WORKFORCE.

A MODERN MERCHANT SHIP IS EXTREMELY COMPLEX AND REQUIRES SPECIALLY TRAINED PEOPLE WITH DIVERSE AND EXTENSIVE PRACTICAL EXPERIENCE. IN 1970, MORE THAN 69,000 AMERICANS WERE EMPLOYED IN 34,000 SEAGOING BILLETS ON THE NEARLY 800 SHIPS OF THE UNITED STATES COMMERCIAL MERCHANT FLEET. TODAY, THERE ARE FEWER THAN 29,000 MERCHANT SEAMEN COMPETING FOR ABOUT 11,000 BILLETS IN A FLEET OF 369 ACTIVE SHIPS.

FROM A DEFENSE PERSPECTIVE, THE NET LOSS OF 23,000 JOBS, AND 40,000 SKILLED OCEANGOING MERCHANT SEAMEN, TRANSLATES DIRECTLY TO A LOSS TO THE POOL OF TRAINED, QUALIFIED MERCHANT SEAMEN NEEDED FOR STRATEGIC SEALIFT IN TIME WAR OR NATIONAL EMERGENCY. WHETHER REACTIVATED FROM "MOTHBALLS" OR PRODUCED BY NEW CONSTRUCTION, ADDITIONAL SHIPS ARE USELESS WITHOUT SKILLED CREWS TO MAN THEM.

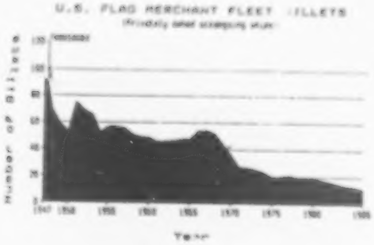

FIGURE 3

THE SHIP CONSTRUCTION MARKET

A MAJOR FACTOR CONTRIBUTING TO THE DECLINE OF THE INDUSTRY HAS BEEN THE VIRTUAL CESSATION OF COMMERCIAL SHIP CONSTRUCTION IN THE UNITED STATES. IN 1980, THERE WERE 69 MERCHANT SHIPS UNDER CONSTRUCTION IN 15 DIFFERENT AMERICAN SHIPYARDS. TODAY THERE ARE NONE.

THAT SITUATION IS DIRECTLY ATTRIBUTABLE TO A WORLD-WIDE SURPLUS OF BOTH SHIPYARDS AND MERCHANT SHIPS, THE INABILITY OF UNITED STATES SHIPYARDS TO COMPETE IN TERMS OF PRICE WITH MOST FOREIGN SHIPYARDS, LITTLE COASTAL OR INLAND MARITIME WORK, THE COLLAPSE OF THE OFF-SHORE ENERGY INDUSTRY, AND THE FAILURE OF THE CONSTRUCTION DIFFERENTIAL SUBSIDY (CDS) PROGRAM. FOREIGN SHIPYARDS, WHICH ARE OFTEN LOWER-COST PRODUCERS THAN AMERICAN SHIPYARDS, HAVE BEEN HELPED TO SURVIVE AND PROSPER BECAUSE THEY FREQUENTLY RECEIVE VARIOUS FORMS OF GOVERNMENT SUPPORT OR HAVE HAD STEADY GOVERNMENT ORDERS.

SHIPBUILDING HAS TENDED TO FOLLOW LOW-COST LABOR, AND AMERICAN SHIPYARDS CANNOT COMPETE WITH FOREIGN SHIPBUILDING FIRMS THAT CAN USE LOW-COST INDIGENOUS LABOR AND CHEAPER MATERIALS OR THAT RECEIVE SUBSTANTIAL SUPPORT FROM THEIR GOVERNMENTS. SHIPBUILDING INDUSTRIES HAVE BEEN TARGETED FOR PRIORITY ECONOMIC DEVELOPMENT IN MANY FAR EASTERN COUNTRIES. SHIPYARDS IN THOSE COUNTRIES ARE PROVIDED WITH DIRECT ECONOMIC AID THROUGH VARIOUS AVENUES. THE PRINCIPAL SHIPBUILDING NATIONS OF THE EUROPEAN COMMUNITY (EC), AS WELL AS NON-EC WESTERN EUROPEAN COUNTIES, ALSO RECEIVE GOVERNMENT ASSISTANCE IN VARIOUS WAYS.

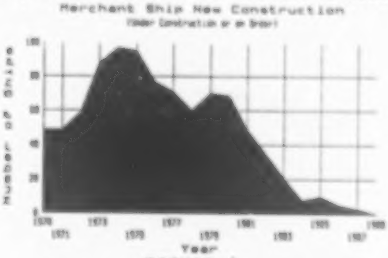

FIGURE 4

IN AN AVERAGE YEAR DURING THE 1970S, 25 COMMERCIAL SHIPS WERE ORDERED FROM AMERICAN SHIPYARDS. IN 1973, 43 COMMERCIAL SHIPS, TOTALING OVER 1.9 MILLION GROSS TONS, WERE ORDERED. ONLY 20 SHIPS ORDERS HAVE BEEN PLACED SINCE 1980, AND NO NEW COMMERCIAL SHIP ORDERS HAVE BEEN PLACED WITH AMERICAN SHIPYARDS FOR WELL OVER 3 YEARS. TODAY THERE IS NOT EVEN ONE OCEANGOING MERCHANT SHIP UNDER CONSTRUCTION IN A UNITED STATES SHIPYARD. THERE ARE, HOWEVER, ~~15~~ SHIPS UNDER CONSTRUCTION FOR U.S. SHIP OPERATORS IN FOREIGN SHIPYARDS, along with 4 oil rigs for a total of 15 "vessels".

11 merchant

(changed by Subcommittee per Commission's request)

IN 1980, THERE WERE 142 OCEANGOING SHIPS, BOTH MILITARY AND COMMERCIAL, UNDER CONSTRUCTION IN 19 DIFFERENT AMERICAN SHIPYARDS. TODAY, ONLY ABOUT 58 SHIPS, ALL MILITARY ARE UNDER CONSTRUCTION IN UNITED STATES SHIPYARDS. THE LAST SEAGOING MERCHANT SHIP ON ORDER FROM AN AMERICAN YARD WAS COMPLETED ON NOVEMBER 9, 1987, AT BAY SHIPBUILDING IN STURGEON BAY, WISCONSIN. ONLY NINE SHIPYARDS ARE TODAY BUILDING SHIPS GREATER THAN 400 FEET IN LENGTH--ALL FOR THE NAVY.

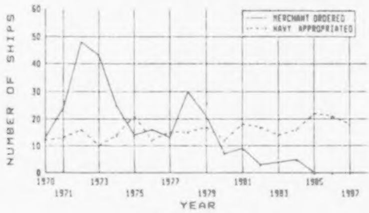
NAVY AND MERCHANT SHIPS ORDERED

FIGURE 5

AT THE SAME TIME THAT COMMERCIAL SHIP CONSTRUCTION DEMAND HAS SHARPLY DECREASED, THE SHIPYARD OIL-RELATED WORKLOAD (FOR EXAMPLE, OIL RIGS, CREW BOATS, AND SUPPLY BOATS) HAS DECLINED TO ALMOST NOTHING, AND THE INLAND AND COASTAL COMMERCIAL WORKLOAD HAS BEEN MORE THAN CUT IN HALF. ALTHOUGH THERE ARE INDICATIONS THAT THIS SEGMENT OF THE INDUSTRY MAY BE RECOVERING, IT HAS A SIGNIFICANT WAY TO GO.

THE TOTAL COLLAPSE OF COMMERCIAL SHIP CONSTRUCTION HAS BEEN A MAJOR FACTOR IN THE DECLINE OF UNITED STATES SHIPBUILDING CAPABILITY. GOVERNMENT CONSTRUCTION ALONE, MOSTLY NAVY AND CONCENTRATED IN A SMALL NUMBER OF SHIPYARDS, IS INSUFFICIENT TO MAINTAIN A DIVERSIFIED SHIPBUILDING AND REPAIR INDUSTRY, INCLUDING SHIPYARD SUPPLIERS, SUFFICIENT TO MEET MOBILIZATION REQUIREMENTS IN TIME OF WAR OR NATIONAL EMERGENCY.

THE NAVY ACCOUNTS FOR 90% OF THE WORKLOAD IN PRIVATE SHIPYARDS TODAY. NEW CONSTRUCTION WORK IS HIGHLY CONCENTRATED IN FEWER THAN A DOZEN SHIPYARDS, WITH MOST OTHERS IN THE INDUSTRY OPERATING AT ONLY A SMALL PERCENTAGE OF PLANT CAPACITY AND OFTEN LOSING MONEY IN THE PROCESS. ONLY THE FEW SHIPYARDS WITH LONG-TERM NAVY CONSTRUCTION PROGRAMS OR REPAIR YARDS LOCATED WITHIN MAJOR NAVY HOME PORT AREAS APPEAR TO HAVE A FORESEEABLE STEADY WORKLOAD.

THE LACK OF COMMERCIAL WORK, COUPLED WITH NAVY PROCUREMENT POLICIES, HAS STRENGTHENED SOME SHIPYARDS BUT HAS ACCELERATED THE CLOSINGS OF OTHERS. THE LARGEST SHIPYARDS REPRESENT A SIGNIFICANT INVESTMENT IN FACILITIES, ENGINEERING TALENT, AND PRODUCTION SKILLS. THEY CANNOT SUCCESSFULLY COMPETE ON A ROUTINE BASIS WITH SMALLER PRIVATE SHIPYARDS AND REPAIR FACILITIES, AS IS DICTATED BY CURRENT COMPETITION POLICIES. WITHOUT AN ADJUSTMENT TO NAVY POLICIES, THE LARGER PRIVATE SHIPYARDS AND THE SHIPBUILDING AND REPAIR INDUSTRY AS A WHOLE WILL CONTINUE TO DECLINE.

IT IS CLEAR THAT MARKET CONDITIONS HAVE BEEN A PRIMARY FACTOR RESPONSIBLE FOR REDUCING THE SHIPBUILDING INDUSTRY TO A LEVEL THAT COULD JEOPARDIZE THE NATIONAL SECURITY OF THE UNITED STATES IF MOBILIZATION WERE REQUIRED TODAY IN THE EVENT OF WAR OR NATIONAL EMERGENCY. AT THE SAME TIME, HOWEVER, IT IS CLEAR THAT DEMAND FOR CONSTRUCTION OF NEW MERCHANT SHIPS IS RELATED DIRECTLY TO THE AVAILABILITY OF SUFFICIENT STRATEGIC SEALIFT, WHETHER FROM GOVERNMENT OR PRIVATE SOURCES, THE MUCH LARGER QUESTION THAT IS THE COMMISSION'S PRIMARY FOCUS.

MR. CHAIRMAN, LET ME NOW TURN TO THE SPECIFIC AREA OF INTEREST TO THE SUBCOMMITTEE AT THIS HEARING: THE CAPABILITY OF THE U.S. SHIPBUILDING AND SHIP REPAIR INDUSTRY.

CURRENT STATUS OF THE UNITED STATES SHIPBUILDING AND REPAIR INDUSTRY

AFTER OPERATING FOR YEARS WITH MINIMAL CAPITAL INVESTMENT, ANNUALLY INFLATING LABOR COSTS, OVERCAPACITY, SLOW TECHNOLOGICAL DEVELOPMENT, AND MARGINAL PRODUCTIVITY UNDER SOLE SOURCE NEGOTIATED CONTRACTS, MANY SHIPYARDS HAVE EXPERIENCED A COMPLETE ABOUT-FACE. HUNDREDS OF MILLIONS OF DOLLARS EACH YEAR HAVE BEEN INVESTED IN CAPITAL IMPROVEMENTS; VIRTUALLY EVERY MAJOR AMERICAN SHIPYARD HAS ADOPTED COMPUTER-AIDED DESIGN AND MANUFACTURING TECHNOLOGIES; WEAK MARKETS HAVE ELIMINATED MARGINAL SHIPYARDS AND OVERCAPACITY; LABOR COSTS HAVE BEEN STABILIZED OR REDUCED FOR SEVERAL YEARS; AND VIRTUALLY EVERY CONTRACT AWARD HAS BEEN THE RESULT OF AGGRESSIVE, FIXED PRICE COMPETITION. BECAUSE OF EFFORTS BY BOTH LABOR AND MANAGEMENT, THE WASTE AND INEFFICIENCY FORMERLY FOUND IN THE AMERICAN SHIPBUILDING AND REPAIR INDUSTRY IS LARGELY DISAPPEARING.

THOSE GAINS, HOWEVER, HAVE TAKEN PLACE AT THE SAME TIME AS THE INDUSTRY HAS BEEN DECLINING PRECIPITOUSLY.

IN JANUARY 1987, THERE WERE 313 OPERATING PUBLIC AND PRIVATE SHIPYARDS, BOAT YARDS, AND SHIP REPAIR FACILITIES, OF VARYING CAPABILITIES AND SIZES, EMPLOYING A TOTAL OF 137,700 PRODUCTION WORKERS.

OF THOSE 313 FIRMS, 54 ARE CAPABLE OF BUILDING OR DRY DOCKING AT LEAST THE SMALLEST PRACTICAL OCEAN GOING VESSEL, ABOUT THE SIZE OF A WORLD WAR II LIBERTY SHIP, AND AN ADDITIONAL 63 FIRMS ARE CAPABLE OF BERTHING AND REPAIRING VESSELS OVER 400 FEET IN LENGTH. THOSE 117 SHIPYARDS ARE CONSIDERED BY THE COMMISSION TO BE THE COMPREHENSIVE SHIPYARD MOBILIZATION BASE. THEY COLLECTIVELY EMPLOY 123,100 PRODUCTION WORKERS OUT OF THE INDUSTRY TOTAL OF 137,700.

DUE PRIMARILY TO A SIGNIFICANTLY REDUCED WORKLOAD, 76 SHIPYARDS OR REPAIR FACILITIES HAVE CLOSED DURING THE LAST 5 YEARS. THE CLOSINGS HAVE SIGNIFICANTLY REDUCED THE CAPABILITY OF THE SHIPBUILDING AND REPAIR INDUSTRY TO MEET MOBILIZATION REQUIREMENTS.

WHEN THE 76 FIRMS CLOSED, CRITICAL PHYSICAL FACILITIES WERE LOST. TWENTY-ONE GRAVING DOCKS AND 17 FLOATING DRYDOCKS, EACH WITH THE CAPABILITY TO DOCK A SHIP 400 FEET IN LENGTH OR GREATER, HAVE BEEN LOST SINCE 1982. ADDITIONALLY, 22 BUILDING WAYS GREATER THAN 400 FEET IN LENGTH HAVE BEEN LOST.

ALSO OF CONCERN IS THE FACT THAT MANY OF THE BUILDING WAYS AND DOCKING POSITIONS LOCATED IN OPERATIONAL SHIPYARDS HAVE DETERIORATED FROM LACK OF USE AND UPKEEP. SIGNIFICANT TIME AND RESOURCES WOULD BE REQUIRED TO RECONDITION THOSE FACILITIES TO SUPPORT SHIPBUILDING AND REPAIR REQUIREMENTS DURING WAR OR NATIONAL EMERGENCY. IN ADDITION, NUMEROUS OTHER PLANT FACILITIES, INCLUDING PIERS, CRANES, AND SHOPS (MACHINE, PIPE, ELECTRICAL, SHEET METAL, AND SO FORTH), HAVE BEEN LOST. MOST OF THE MACHINE TOOLS AND OTHER PLANT EQUIPMENT IN THOSE FACILITIES HAVE BEEN SOLD OR SCRAPPED, OR HAVE DETERIORATED BEYOND CAPABILITY OF REACTIVATION.

SHIPYARDS ARE COMPOSED OF PEOPLE AS WELL AS FACILITIES, AND THE COMMISSIONERS FOUND ALARMING TRENDS IN SHIPYARD MANPOWER.

SINCE 1982, OVER 52,500 PRODUCTION WORKER JOBS HAVE BEEN LOST BECAUSE OF SHIPYARD CLOSINGS OR BECAUSE OF WORKFORCE REDUCTIONS IN OPERATING SHIPYARDS. CURRENTLY, SHIPYARD PRODUCTION WORKERS AND EXPERIENCED SHIPYARD MANAGEMENT PERSONNEL ARE CONCENTRATED IN THE LARGEST PRIVATE SHIPYARDS, WHICH ARE ENGAGED PRIMARILY IN NAVY NEW CONSTRUCTION WORK. THE FIVE LARGEST SHIPYARDS, WITH A TOTAL OF 54,300 PRODUCTION WORKERS, AND THE EIGHT NAVAL SHIPYARDS, WITH A TOTAL OF 34,400 PRODUCTION WORKERS, EMPLOY ABOUT 65% OF THE TOTAL INDUSTRY WORKFORCE.

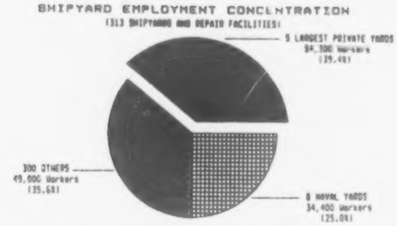

FIGURE 6

THE WEST AND GULF COASTS HAVE BEEN AFFECTED MOST BY THE CONTRACTION OF THE SHIPBUILDING INDUSTRY. SIXTY-TWO PRIVATE SHIPYARDS, BOAT YARDS, AND SHIP REPAIR FACILITIES ON THE WEST COAST EMPLOYED 14,700 PRODUCTION WORKERS AT THE BEGINNING OF 1987, DOWN FROM THE 25,400 WORKERS EMPLOYED IN 1982. ADDITIONALLY, 15 FIRMS ON THE WEST COAST HAVE CLOSED SINCE 1982, RESULTING IN THE LOSS OF ANOTHER 5,300 PRODUCTION WORKER JOBS.

THE 90 PRIVATE SHIPYARDS, BOAT YARDS, AND SHIP REPAIR FACILITIES ON THE GULF COAST EMPLOYED 23,200 PRODUCTION WORKERS AT THE BEGINNING OF 1987, DOWN FROM THE 31,200 EMPLOYED IN 1982. ADDITIONALLY, 28 FIRMS ON THE GULF COAST HAVE CLOSED SINCE 1982, RESULTING IN THE LOSS OF ANOTHER 7,000 PRODUCTION WORKER JOBS.

IN CONTRAST, THE 125 ATLANTIC COAST PRIVATE SHIPYARDS, BOAT YARDS, AND SHIP REPAIR FACILITIES OPERATING AT THE BEGINNING OF 1987 EMPLOYED 60,300 PRODUCTION WORKERS, DOWN BY ONLY 500 JOBS FROM 1982. ON THE OTHER HAND, 22 FIRMS ON THE ATLANTIC COAST HAVE CLOSED SINCE 1982, RESULTING IN THE LOSS OF ABOUT 12,000 PRODUCTION WORKER JOBS. THE TRENDS FOR INLAND AND GREAT LAKES SHIPYARDS HAVE BEEN SIMILAR TO THOSE OF THE ATLANTIC COAST SHIPYARDS: A CONTRACTION, BUT NOT AS SHARP OR SEVERE AS THAT AFFECTING THE WEST COAST YARDS.

WITH THE CONSTRUCTION OF THE 600-SHIP NAVY VIRTUALLY COMPLETED AND THE DEFENSE BUDGET ONCE AGAIN UNDER PRESSURE FOR REDUCTION, NAVY NEW CONSTRUCTION DURING THE NEXT DECADE OR MORE WILL PROBABLY DECLINE TO A SUSTAINING LEVEL. THE NUMBER OF PRODUCTION WORKERS REQUIRED TO ACCOMPLISH THAT MINIMUM LEVEL OF NAVY WORK IS PROJECTED TO BE 44,000, DOWN 14% FROM THE CURRENT 51,000. THAT IS COMPARABLE TO THE NUMBER OF PRODUCTION WORKERS EMPLOYED BUILDING NAVY SHIPS IN 1980, PRIOR TO THE PROGRAM FOR THE 600-SHIP NAVY. THE NUMBER OF PRODUCTION WORKERS REQUIRED FOR NAVY SHIP MAINTENANCE AND REPAIR IS PROJECTED TO BE 46,000, DOWN FROM THE CURRENT 49,000.

WITH NEW COMMERCIAL SHIP ORDERS LIMITED TO COASTAL AND INLAND CRAFT, AND A VERY SMALL NUMBER OF JONES ACT SHIPS, THE NUMBER OF PRODUCTION WORKERS INVOLVED IN COMMERCIAL NEW CONSTRUCTION IS PROJECTED TO DROP TO FEWER THAN 1,000 AND REMAIN AT THAT LEVEL UNTIL NEW OCEAN-GOING SHIP ORDERS ARE PLACED. COMMERCIAL SHIP REPAIR WORKLOAD IS PROJECTED TO REMAIN CONSTANT, BUT WILL SUPPORT ONLY ABOUT 3,000 PRODUCTION WORKERS. ALL OTHER GOVERNMENT WORK AND OTHER NON-SHIP WORK IS EXPECTED TO REMAIN RELATIVELY CONSTANT AND TO CONTINUE TO BE ACCOMPLISHED BY THE SMALL- AND MEDIUM-SIZED SHIPYARDS.

IT SHOULD BE NOTED THAT, WHEN SHIPS ARE NOT BUILT IN A SHIPYARD FOR A LONG PERIOD, VITAL PRODUCTION WORKER AND MANAGERIAL SKILLS UNIQUE TO NEW SHIP CONSTRUCTION ARE LOST. FURTHERMORE, PRODUCTION WORKER AND MANAGERIAL SKILLS, AND THE PLANT FACILITIES REQUIRED FOR COST-EFFICIENT SHIP CONSTRUCTION, ARE DIFFERENT FROM THOSE REQUIRED FOR COST-EFFICIENT SHIP REPAIR.

SHIPYARD SUPPLIERS

MR. CHAIRMAN, IN ADDITION TO THE DECLINING SHIP CONSTRUCTION INDUSTRY, SHIPYARD SUPPLIERS, NAVAL ARCHITECTURE FIRMS AND THE UNITED STATES INDUSTRIAL BASE AS A WHOLE HAVE DECLINED IN SIMILAR FASHION.

THE COMMISSIONERS CONCLUDED THAT THE UNITED STATES HAS BECOME ALARMINGLY DEPENDENT UPON FOREIGN SOURCES OF CRITICAL EQUIPMENT, RANGING FROM MAJOR PROPULSION SYSTEM COMPONENTS TO PRECISION BEARINGS, FOR NAVY AS WELL AS FOR COMMERCIAL SHIPS. IN SOME CASES, THE NEWEST, MOST TECHNOLOGICALLY ADVANCED, AND MOST IMPORTANT NAVY WEAPONS SYSTEMS RELY UPON FOREIGN MANUFACTURED COMPONENTS.

SEA-GOING SHIPS REQUIRE A SIGNIFICANT RANGE OF CRITICAL AND BASIC MACHINERY, EQUIPMENT, AND MATERIALS. FIFTY TO SIXTY PERCENT OF THE CONSTRUCTION COST OF A COMMERCIAL VESSEL OR NAVY COMBATANT IS SPENT OUTSIDE OF THE SHIPYARD FOR THE PROCUREMENT OF SUCH MACHINERY, EQUIPMENT, AND MATERIALS.

THE SEGMENT OF THE SHIPYARD SUPPLIER BASE THAT PROVIDES SHIP ENGINES (GAS TURBINES, STEAM TURBINES AND DIESEL ENGINES) HAS BEEN REDUCED BY APPROXIMATELY ONE-HALF SINCE 1980.

THERE WERE SEVEN GEAR MANUFACTURERS PRODUCING REDUCTION GEARS FOR LARGE SHIPS IN 1980. TODAY THERE ARE ONLY TWO.

THE NUMBER OF FIRMS MANUFACTURING PROPULSION SHAFTING FOR LARGE APPLICATIONS HAS BEEN REDUCED FROM THREE TO TWO.

LARGE MARINE PROPELLER MANUFACTURERS IN THE UNITED STATES HAS BEEN REDUCED BY 50% SINCE 1980.

THE ELECTRICAL AND ELECTRONIC COMPONENT INDUSTRIES ARE CONSIDERED "HEALTHY" AT THE "PRIME" LEVEL BUT ARE BECOMING INCREASINGLY CONSTRAINED IN MANY AREAS AT THE SUB-TIER LEVEL.
THE LIST GOES ON TO INCLUDE QUIET BALL BEARINGS, PIPE AND TUBING, AND WELD FILLER WIRE, TO NAME A FEW.

THE CURRENT CONDITION OF THE SHIPYARD SUPPLIER INDUSTRY IS AT BEST DISTRESSING, BUT THAT IS NOT THE END OF THE PROBLEM. ALONG WITH THE LOSS OF SPECIFIC INDUSTRIAL CAPABILITY, THERE HAS BEEN A SIGNIFICANT LOSS OF SKILLED LABOR, PHYSICAL FACILITIES, TOOLING, AND SUPPORT CAPABILITY FOR SPECIALIZED MANUFACTURING. WITH TIME AND CONSIDERABLE CAPITAL INVESTMENT, THE PHYSICAL FACILITIES COULD BE REBUILT AND RE-TOOLED. THE QUESTION REMAINS, HOWEVER, OF WHETHER THERE WOULD BE SUFFICIENT TIME TO ACCOMPLISH THE NEEDED REBUILDING DURING MOBILIZATION. AS IS THE CASE WITH SHIPYARD MANAGERS AND SKILLED SHIPYARD WORKERS, SKILLED CRAFTSMEN (MACHINISTS, WELDERS, FORGERS, MOLDERS, ASSEMBLERS, AND OTHERS) CANNOT BE TRAINED OVERNIGHT.

ABILITY OF THE SHIPBUILDING AND REPAIR INDUSTRY TO MEET MOBILIZATION REQUIREMENTS

THE COMMISSION CONDUCTED AN EXTENSIVE ANALYSIS TO DETERMINE IF THE SHIPBUILDING INDUSTRY COULD ACCOMPLISH ALL ASSIGNED MOBILIZATION TASKS WITHOUT JEOPARDIZING NATIONAL SECURITY. THE ANALYSIS CONSIDERED ALL SHIPYARD MOBILIZATION REQUIREMENTS IN TWO PHASES: SURGE AND SUSTAINING. THE ANALYSIS OF THE SHIPBUILDING AND REPAIR INDUSTRY EXAMINED FACILITIES, SHIPYARD MANPOWER, AND SOME MAJOR SHIP COMPONENTS AND SYSTEMS NEEDED TO MEET THE SHIPYARD MOBILIZATION REQUIREMENTS.

THE DEMAND PLACED ON THE SHIPBUILDING AND REPAIR INDUSTRY TO SUPPORT STRATEGIC SEALIFT IN A MOBILIZATION IS DERIVED FROM SEVERAL STATED REQUIREMENTS:

- REACTIVATE SHIPS IN THE READY RESERVE FORCE

- COMPLETE INSTALLATION OF SEALIFT ENHANCEMENT FEATURES (SEF)

- REPAIR BATTLE-DAMAGED NAVY AND MERCHANT SHIPS

- ACCELERATE ON-GOING NAVY AND MERCHANT SHIP MAINTENANCE AND REPAIR

- ACCELERATE ON-GOING NEW CONSTRUCTION (NAVY, COAST GUARD, AND MERCHANT MARINE)

- REACTIVATE THE SHIPS IN THE NATIONAL DEFENSE RESERVE FLEET AND, IF REQUIRED, THE INACTIVE SHIPS IN NAVY CUSTODY (ISNAC)

- CONSTRUCT ADDITIONAL NAVY AND MERCHANT SHIPS

WHEN CONSIDERED ON A COAST-BY-COAST BASIS, ONLY THE EAST AND GULF COASTS WOULD HAVE SUFFICIENT MANPOWER TO ACCOMPLISH ALL REQUIREMENTS ON SCHEDULE. IF CURRENT TRENDS CONTINUE ON THE WEST AND GULF COASTS, THE PROBLEM WILL ONLY GET WORSE AND COULD ADVERSELY AFFECT REACTIVATION OF THE READY RESERVE FORCE.

ALTHOUGH THE SHIPBUILDING AND REPAIR INDUSTRY WOULD BE ABLE TO MEET THE SURGE PHASE REQUIREMENTS DURING MOBILIZATION, THE SUSTAINING PHASE OF MOBILIZATION WOULD BE CONSTRAINED BY SHIPYARD FACILITIES, MANPOWER, AND MATERIAL SUPPLIER INDUSTRIES AT DIFFERENT TIMES. ADEQUATE SHIP BUILDING POSITIONS ARE NOT AVAILABLE TO MEET NAVY OR MERCHANT MARINE CONSTRUCTION REQUIREMENTS DURING A LONG MOBILIZATION. SHIPYARD MANPOWER IS CURRENTLY AT A LEVEL THAT WOULD CONSTRAIN MOBILIZATION EFFORTS BEYOND THE SURGE PHASE, ESPECIALLY ON THE WEST COAST. GIVEN CURRENT AND PROJECTED CAPABILITIES, THE SHIPYARD SUPPLIER INDUSTRIES COULD NOT SUPPORT MOBILIZATION NEW CONSTRUCTION REQUIREMENTS DURING A PROLONGED CONFLICT.

THE COMMISSION HAS CONCLUDED THAT THE SHIPYARD SUPPLIER INDUSTRIES CANNOT NOW SUPPORT NAVY AND MERCHANT MARINE SHIP CONSTRUCTION REQUIREMENTS DURING A MOBILIZATION OR A PROLONGED CONFLICT. ANALYSIS OF THE CAPABILITIES OF THE SHIPYARD SUPPLIER INDUSTRIES INDICATES THAT, IN 1987, SEVERAL MAJOR ITEMS COULD NOT BE PROVIDED TO THE DESIGNATED SHIP CONSTRUCTION SHIPYARDS ON SCHEDULE. BASED ON CURRENT NAVY DATA, IT WAS DETERMINED THAT EIGHT MAJOR TYPES OF COMBAT SYSTEMS AND NINE MAJOR HULL, MECHANICAL, AND ELECTRICAL COMPONENTS CURRENTLY INSTALLED ON NAVY SHIPS HAVE SIGNIFICANT SHORTFALLS IN DOMESTIC MANUFACTURING CAPACITY. DELAY IN THE PROVISION OF THOSE MAJOR ITEMS WOULD DELAY COMPLETION OF NUMEROUS NAVY SHIPS.

THE EFFECT OF SHORTFALLS IN THE SHIPYARD SUPPLIER INDUSTRIES WOULD NOT BE AS SIGNIFICANT ON MERCHANT SHIP NEW CONSTRUCTION, PRIMARILY BECAUSE OF THE DELAY IN CONSTRUCTION STARTS CAUSED BY THE LACK OF ADEQUATE BUILDING POSITIONS. WITHOUT A SIGNIFICANT INCREASE IN DIESEL ENGINE AND REDUCTION GEAR MANUFACTURING CAPACITY, HOWEVER, MERCHANT SHIP CONSTRUCTION WOULD BE FURTHER CONSTRAINED BECAUSE OF COMPETITION FOR AN INSUFFICIENT NUMBER OF DIESEL ENGINES AND REDUCTION GEARS.

AS A RESULT OF THEIR STUDY, THE COMMISSIONERS CONCLUDED THAT MAINTAINING THE SHIPBUILDING AND REPAIR SEGMENT OF THE INDUSTRIAL BASE REQUIRED TO SUSTAIN A PROTRACTED GENERAL WAR IS ESSENTIAL TO DETERRING OR WINNING SUCH A WAR. THE BASE OF SHIPYARDS AND REPAIR FACILITIES, AND THEIR INDUSTRIAL SUPPLIERS IS, CURRENTLY INADEQUATE IN THAT SENSE AND IS CONTINUING TO DETERIORATE AT AN ALARMINGLY PROGRESSIVE RATE.

CONCLUSION

MR. CHAIRMAN, OFFICIALS AT THE HIGHEST LEVELS OF GOVERNMENT, INCLUDING THE PRESIDENT AND LEADERSHIP IN THE HOUSE AND SENATE, STATE THAT THE UNITED STATES MERCHANT MARINE HAS A VITAL ROLE IN THE NATION'S ECONOMY AND DEFENSE. NONETHELESS, THE MERCHANT MARINE AND ITS RELATED SHIPBUILDING, SHIP REPAIR, AND SUPPLIER INDUSTRIES ARE IN EXTREMIS. ALTHOUGH THE NATION'S MILITARY STRATEGY REQUIRES USE OF MERCHANT SHIPPING ASSETS IN TIME OF CRISIS, AND PARTS OF THAT STRATEGY ARE PREDICATED UPON THE AVAILABILITY OF SHIPS, CREWS, AND SHIPYARDS, WARTIME AVAILABILITIES DEPEND ON THE ADEQUACY OF THE RESOURCES EXISTING IN TIME OF PEACE. THAT IS CERTAINLY ESPECIALLY TRUE FOR THE SHIPBUILDING INDUSTRY, WHICH WOULD HAVE TO BE IN A POSITION IN TIME OF CONFLICT TO MAKE UP ANY PEACETIME SHORTAGE OF SHIPS, BOTH MILITARY AND COMMERCIAL. THE NATION SIMPLY CANNOT AFFORD TO HAVE NEITHER THE SHIPS NOR THE INDUSTRIAL CAPACITY TO BUILD THEM QUICKLY AND WELL, BUT THAT IS THE SITUATION THAT APPEARS TO BE DEVELOPING AT AN ACCELERATING RATE. IT IS THE PROSPECT OF SUCH A DANGEROUS SITUATION FOR OUR NATION THAT MOST CONCERNS THE COMMISSIONERS, THAT UNDERLIES THEIR FIRST REPORT, AND THAT PROVIDES THE IMPULSE AND THE MOTIVATION FOR THEIR ONGOING EFFORTS.

THANK YOU, MR. CHAIRMAN.

QUESTIONS SUBMITTED BY THE HONORABLE MIKE LOWRY, MEMBER, COMMITTEE ON MERCHANT MARINE AND FISHERIES, TO THE COMMISSION ON MERCHANT MARINE AND DEFENSE; ALONG WITH ANSWERS FURNISHED BY THE COMMISSION, 24 FEBRUARY 1988

IN YOUR REPORT YOU STATE THAT GOVERNMENT PROCUREMENT POLICIES, THAT HAVE EMPHASIZED BID PRICE RATHER THAN VALUE, HAVE UNACCEPTABLY HARMFUL EFFECTS FOR BOTH THE MERCHANT MARINE AND SHIPBUILDING AND REPAIR INDUSTRIES.

- **WHAT ARE THE HARMFUL EFFECTS OF SUCH POLICIES?**
- **IN THIS REGARD, DO YOU FEEL A CHANGE IN GOVERNMENT POLICIES IS CALLED FOR?**
- **IF SO, WHAT DO YOU ENVISION?**

The Commissioners have addressed these questions in their first report. The Commissioners stated:

> United States government departments and agencies have not seemed fully supportive of the United States flag merchant marine, and several policies and practices have had harmful effects on the American maritime industries:
>
> - The reliance of American flag operators on Department of Defense cargo has become so dominant that at times the competition has become destructive, driving Department of Defense rates below a fair level of compensation for the costs of cargo carriage; short-term government savings are obtained only at long-term costs to the United States flag operators.
>
> - Within the government itself, various agencies at times have attempted, with varying levels of success, to ignore the cargo reservation statutes in order to ship government-impelled cargoes on foreign flag ships at lower cost to their own budgets. (p. 12)
>
> Department of Defense acquisition policies, which have emphasized obtaining products and services at the lowest possible cost, have also been disruptive to the maritime industries. (p. 14) .

The Commissioners went on to say:

> Navy ship construction and repair work is solicited in accordance with the Competition in Contracting Act and other government procurement policies and regulations. The Navy has shifted to greater reliance on "fixed-price contracts" instead of "cost contracts" for both ship construction and repair work.

> In the very weak shipbuilding market that exists, American shipyards have no alternative to Navy or other government work. The emphasis on competition, coupled with the shift to "fixed-price contracts," has encouraged productivity improvements and has driven bid prices down to the point where, in most cases, they appear to have bottomed out.
>
> . . . . The largest shipyards represent a significant investment in facilities, engineering talent, and production skills. They cannot successfully compete on a routine basis with smaller private shipyards and repair facilities, as is dictated by current competition policies. Without an adjustment to Navy policies, the larger private shipyards and the shipbuilding and repair industry as a whole will continue to decline. (p. 37)
>
> The United States industries also suffer from the effects of government policies, such as the Competition in Contracting Act (CICA) and the NATO Rationalization, Standardization, and Interoperability (RSI) program.
>
> Along with those policies, the waiver of the "Buy American Act" through the use of bilateral agreements by the United States government, and the increasing pressure on both the Department of Defense and industry to offer "offsets" required to conduct business abroad, also contribute to the ills facing American industries. (p. 41)

I expect that the Commissioners will address the necessary changes to government policies discussed in your questions in their second report, scheduled to be submitted to the President and the Congress in December 1987.

o **IN YOUR REPORT, SHIPYARDS IN THE PACIFIC NORTHWEST WERE NOT EXAMINED. WHY NOT?**

The Commission's analysis did include examination of shipyards in the Pacific Northwest as part of the total United States shipyard base. The yards are included in the data bases contained in Appendices E-1 and E-2 to the first report.

The Commissioners did not consider the shipyards in the Pacific Northwest as a separate analytic group, since their characteristics and problems put them in the overall subset of West Coast yards. The Commissioners, in the report itself, considered shipyards by coast (West, Gulf, East, and Great Lakes) and described the problems affecting West Coast shipyards as a group. The Commissioners noted the severe problems facing West Coast yards, and stated that, if current trends continue, "the problem will only get worse and, by the year 2000, could adversely affect reactivation of the RRF."

Statement By
John J. Stocker
President
Shipbuilders Council of America
Before
Subcommittee on Merchant Marine
Committee on Merchant Marine and Fisheries
House of Representatives
On
Potential for Revitalizing
the Shipbuilding Industry
December 8, 1987

Mr. Chairman, and members of the Subcommittee on Merchant Marine, I am John J. Stocker, President, Shipbuilders Council of America - the national trade association representing America's shipbuilders, ship repairers, and manufacturers of marine equipment. A list of our membership is attached. This list will show that 25 companies with 34 facilities are members along with 18 marine equipment manufacturers and 4 naval architect firms. I might add that we represent 94% of the total shipbuilding and ship repair workers in the United States.

The Subcommittee on Merchant Marine is already aware of the current status of our industry. The Subcommittee knows that in the face of the greatest naval fleet rebuilding effort in peacetime the industry has sustained dramatic reductions in the number of shipyards and production workers employed in those shipyards. In October 1982, there were 110 shipyards in the United States, according to one Navy study, employing 112,000 production workers. Today that number has declined to 74 shipyards employing 85,000 production workers. These reductions amount to a 34% drop in the number of shipyards and a 24% drop in the number of production workers. All of this occurred in the space of four years and with a level of spending on Navy shipbuilding programs that has been unprecedented.

The shipbuilding business is an expensive proposition given the nature of its economics. A shipyard requires an operating plant, waterfront property, and, in these days of increasing technological complexity, a highly trained work force. If a shipyard closes, the physical space and prime waterfront property are irreplaceable given the magnitude of dollars that can be made in real estate development. A highly trained work force is even more valuable and also irreplaceable not only if a yard closes, but when layoffs occur as well. As work load declines at a particular shipyard, layoffs are the general rule. These workers are frequently forced to seek work in other occupations that can provide them with a much more stable employment. In one case, a shipyard was successful in winning a Navy contract that required recall of 1,200 workers from lay-off status. This yard was successful in attracting only 100 workers back to the yard.

On the other hand, this pattern of cyclical behavior in managing work load inventory has been characteristic of shipyards in peacetime. Yet, what is unique about the current experience is the government's role in this downturn. The Administration has lost sight of the role of shipbuilding in the peacetime economy and in national security. In general, it is a fact of life for shipyard managers that the behavior of government affects their day-to-day business decisions. In 1946, a report by the Harvard Business School noted that:

> "(1) . . .the contributions of ships and shipyards to security and prosperity are not equal;
>
> "(2) that the nature of the shipping and shipbuilding industries and the reason for their existence in the United States has not been generally appraised;
>
> "(3) that the requirements of national security are so much greater than the requirements of national prosperity that economic forces alone will not produce either the kind or the amount of shipping and shipbuilding which the country needs for its national welfare; and

"(4) that correct understanding of these industries and appropriate action are essential to national welfare."

Although these words were written in 1946, they are as relevant today as they were then. Despite the postwar surpluses in both shipping and shipbuilding capacity, an attempt was made by all parties to structure programs that would assist the industry, such as the original Mariner Program. Our government's abandonment of the industry in the current period flies in the face of historical precedent.

Like the Harvard report, the Subcommittee will need to make recommendations that will galvanize the government into action. The government must assess the extent of capacity in the shipbuilding industry that is required within the framework of industrial capability as an element of our national economy and as a factor in the mobilization of our industrial resources for war or national emergency.

The members of the Shipbuilders Council have consistently said that the Defense Department and Transportation Department need to jointly consider the mobilization requirements for the shipbuilding industry, to publish those findings, and to engage in a dialogue with the shipbuilding community concerning assumptions, data, and conclusions. This Administration has performed studies, but never publicly released them, and has refused to establish a dialogue with the industry concerning its long-term future. Its position appears to be that the government will not interfere with the functioning of the marketplace. Other commentators have expressed to shipbuilders the view that dependence on the government needs to be ended.

Yet, it is a fact of life that governments interfere in their maritime industries because they have made a policy decision that some capability is a public good. We cannot compete in the international market because governments have determined to join with their shipbuilding and shipping firms to acquire international market shares. Thus, we are being asked to enter the international market, alone as private individuals, arrayed against the greater force of governments and societies supporting our foreign competitors.

What are the implications of the character and health of the industrial base for defense purposes? The answer to that question can serve as a backdrop for developing the solutions necessary to keep this industry functioning as a viable element of the national defense.

The miracle of shipbuilding that occurred in World War II would not have occurred without the significant preplanning and order placement that characterized the period prior to 1941. By the time of the attack on Pearl Harbor, over 200 merchant ships were on the building ways in American shipyards. This "pump-priming" allowed the industry to be geared to accept the substantial increase in orders that came in the 1941-1945 period. In fact, it is possible to trace the gathering of industrial forces back to 1933 when President Franklin Delano Roosevelt instituted an increased naval shipbuilding program, not only to increase the size and capability of the fleet, but also to preserve jobs in an industry and nation racked by depression.

The enactment of the Merchant Marine Act of 1936 established the mechanism by which government could determine the types of ships that were ordered for commercial and defense purposes and the shipyards needed to build them. The planning process allowed for ship designs to be created and refined by working with shipyard personnel to inject comments on "productivity." Priorities for the distribution of raw materials and finished goods to the industry were established. In other words, the industry was gradually phased into the World War II experience for eight years prior to the entry of the United States into the war. It was the gradual phasing in of the industrial capacity that made it possible for the industry to produce merchant ships at a faster rate before German U-boats could sink them.

Why had this occurred? It occurred because there was a concrete decision by the governmental leadership that there were both economic and national security reasons for maintaining the base. Job creation in a depression environment was critical. There was also a lesson learned in

World War I that ships would not be produced overnight. Few people realize that not a single ship ordered from U.S. shipyards following the April 1917 declaration of war ever saw action. Thus, the planners for the next World War made it possible to avoid the mistakes of the earlier conflict.

The Shipbuilders Council believes that this Subcommittee must not only assert that an industrial base is needed but it also must recommend the steps that must be taken to hold the industry in an effective reserve of industrial mobilization potential. Once the government has determined that the industry needs to be maintained, there are a number of programs both in terms of near and long-term potential that must be developed.

1. Ships for Export

a. Negotiation

With all the current discussion on trade issues, it seems entirely proper to mention that this industry has not had an order for a new ship for the foreign trade since 1981. This should not be surprising in a world where we receive no government financial support while our foreign competitors receive extensive assistance. Thus, the American shipbuilding industry has no hope of competing on a price basis in the international market.

A solution to this problem is to create a two-step program that will level the playing field. First, we can strengthen the hand of the Special Trade Representative and allow him to negotiate with our trading partners to reduce their levels of support to their own shipyards. To encourage these nations to do so, we recommend the establishment of an "Intervention Fund" that would allow the United States to match the financial support of the recalcitrant nation. There is a precedent for this kind of subsidy in the recent sale of grain to the Soviet Union where the U.S. price was offset to bring it into line with world prices. We are proposing a similar mechanism for shipbuilding. Legislation is being sought that would establish this fund at $1.5 billion.

b. Financial Aid

The attempt to negotiate away subsidy practices in foreign countries could be coupled with a program to export commercial ships for either U.S. or foreign operators. A fund would be created which would provide direct payments to shipyards competing for contracts and would be used to offset foreign price differentials. The government would select the shipyard proposal that would include, among other factors, the lowest percentage of subsidy to cost. Thus, competition would continue to be served, while protecting American firms from predatory pricing practices. Shipyards would market their designs worldwide and apply to the government for support. The actual difference from the old Construction-differential Subsidy program is that it would offer direct support to shipyards and it would not necessarily require direct links with U.S.-flag operators.

2. Clean-Product Tankers

The Council's handy-sized, clean product tanker proposal is comprised of three elements.

a. Preference for U.S.-built, U.S.-flag tankers

As you are aware, the government is currently procuring tankers for incorporation into the Ready Reserve Force. These procurements are necessary to offset the decline in U.S.-flag capability, particularly in Jones Act crude oil and product carriers. The Council believes that before American taxpayer dollars are spent to acquire foreign-built ships for the RRF, commercially obsolete U.S-flag ships possessing useful military characteristics should be procured for the reserve fleet. Adequate safeguards can be established to keep acquisition prices within competitive ranges. In addition, a national preference policy would withdraw aging, inefficient tonnage from the Jones Act and foreign trades and allow for market conditions to create a demand for newer and more efficient tonnage.

b. Sealift Tankers

Currently nine sealift tankers operated by the Military Sealift Command do not satisfy the requirements of the Port and Tanker Safety Act. These ships, all built in the early 1970s, would make useful additions to the Ready Reserve Force. These ships could be replaced by new, clean product carriers to satisfy the peacetime military petroleum movement requirements. Such replacement ships would have lower operating costs. Recent studies have shown that the five-year cost per ton of petroleum delivered would drop from the current level of $10.13 to $9.13. The Council believes that about five or six ships could replace the current nine for a total of approximately $300-$330 million in construction costs. These costs under a build and charter scheme would be amortized over the economic life of the ship and be reflected in the charter hire rates.

A drawback to this approach would be the limitations placed on the length of contract permitted under present law. MSC charters are limited to three years for new ships with two options of 17 months each. It is unlikely that any operator would invest in these ships unless the law permitted longer charter periods. The Senate has recently passed an amendment to the FY 1988 National Defense Authorization Bill that directs the Navy to proceed with this program. The Council applauds this action by the Senate and would urge this Subcommittee to encourage your colleagues in the Conference Committee on the authorization measure to support the Build and Charter program for tankers.

c. Construction of Foreign-Trade Tankers

As the Subcommittee is aware, the U.S.-flag liquid bulk fleet carries an insignificant amount of U.S. cargo in the foreign trades. In the past, there was relatively little concern over the potential impact on national security of a limited U.S.-flag presence in the bulk fleet. However, recent Defense Department sealift studies have concluded there exists a shortfall in the nation's capability in handy-sized product carriers. In fact, we understand the Navy believes that as many as 129 ships are needed to fulfill sealift requirements. In addition, economic conditions are dictating the possibility of increased tanker demand by private operators as refineries move closer to the wellhead and transportation of refined products shifts. A recent news article indicated that the Overseas Shipholding Group is currently building four 40,000 dwt product carriers in a foreign shipyard. These ships would be perfect to meet national security needs but they are too few, will fly a foreign flag, will maintain labor in foreign shipyards, and provide jobs for foreign seamen.

The combination of potential economic and national security policy forces coalescing into a genuine program of shipbuilding is a rare event and one that should be seized. It is clear to us that a program of vessel construction will bolster employment in the shipyards, improve the size of the U.S.-flag liquid bulk fleet, and increase scarce civilian mariner jobs.

There are three potential options for financing the construction of these tankers.

i. Direct government procurement of these product carriers for charter to private operators. This approach would be similar to the very successful Mariner Program of the early 1950s. Here the government builds the ships for its own account and charters them to U.S. operators to transport petroleum products in the international trades.

ii. Another option would be to establish a cargo preference regime for imported petroleum products. This preference would apply only to imports transported on U.S.-built ships. By creating such a preference, the private market would finance and construct the ships to carry products in a restricted market.

iii. Another approach would offer tax credits to shippers that would offset the cost of using higher cost U.S.-built, U.S.-flag tonnage. Again, the private market would respond to meet the demand created, as shippers would be able to calculate the potential reduction in operating costs to themselves, which would make U.S. ship prices competitive in the international market. There would be a reduction in tax revenues, at least initially, but this would be offset by the tax receipts coming in from shipyards and operators.

All of these schemes, and there are others, are needed to offset the pricing practices of our international competitors who are supported by their own governments, while we face the world unaided.

3. Government Support for Foreign Military Sales

The shipbuilding industry has shown that its genuine expertise is in the area of building technologically complex warships. It is generally acknowledged that the development of FMS programs requires some degree of government involvement in the articulation of those programs. There are currently several ship designs resident within the U.S. industry that could be marketed worldwide and could be found appealing if FMS financing could be applied. We believe the Subcommittee should support the development of a shipbuilding support team within the State Department, International Security staffs of the Office of the Secretary of Defense, and the Defense Security Assistance Agency to actively promote their designs to allied navies.

There needs to be fostered a joint venture between government and industry in the development of this market. This joint venture must be created on the part of government so that conflicts with international security policies do not arise. These policy considerations require that government involve itself. We desire such involvement because of the fact that our international competitors, principally the Europeans, are receiving the direct participation of their governments in making such sales around the world.

In addition, we need the following direct actions to make this effort successful:

- Congress should amend existing law to allow foreign selling costs to be recovered in normal government contract overhead rates. This is a normal cost of doing business and international business is not inexpensive.

- The process for approval of export licenses needs to be streamlined.

- More, rather than less, resources should be directed to the DSAA as a way of assisting industry and customers in financing a particular procurement.

- A policy should be established that would allow government and industry to work closely together in the identification of potential markets and financing options available.

- On its part, industry would market itself and possibly perform joint designs for the foreign markets.

There are a number of things that can be and should be done to penetrate this market. Industry is willing to do its part, but government support in this endeavor is vital for the effort to succeed. The goal is simple, sustain the industry at home through providing our allies and friendly navies with the ships that they need.

4. Preserve the Integrity of the Jones Act

One feature of the Administration's actions over the past few years has been a series of consistent attacks on lifting the domestic market restrictions of the Jones Act. Efforts to bend the rules on barge construction, export of domestically-produced oil, and repayment of construction subsidies for ships built originally for the foreign trade create uncertainties in the minds of corporate decision-makers. These uncertainties lead to decisions to forego newbuilding. As a result, the quality of transportation services erode as the domestic fleet ages. We believe that demand for new tonnage to replace aging inventories has been stifled by these attempts to redefine the Jones Act trade.

We would ask the Subcommittee to: oppose CDS repayment, restrict the movement of domestically-produced oil to U.S. transportation systems, restrict the construction of barges or other watercraft used in the Exclusive Economic Zone of the United States to U.S. yards, and prohibit foreign-produced oil rigs to be placed on federally-owned and leased property on the Outer Continental Shelf.

These are real potential markets for U.S. yards and they must be sustained.

5. Other Issues

a. Title XI Ship Mortgage Guarantee

One of the areas where shipyards have difficulty is in the financing of new construction projects. The Adminis-tration has consistently supported efforts to curtail loan guarantee programs. As one of the last in-place promotional programs left to us, we urge the Subcommittee to express its support for the Title XI program. A number of proposals are being made to the Maritime Administration that involve the construction of U.S.-flag cruise ships. We believe these applications should be supported. Since there is an emerging requirement in the Defense Department for troop carriers, we believe the cruise ships would have an applicability to solving part of the problem. We would also support a proposal to restructure Title XI to focus on shipbuilding projects and to forego energy projects, at least until such time as the energy market stabilizes.

b. Car Carriers

Recently, efforts have been made to transport a portion of Japanese and Korean automobiles exported to this country on U.S.-flag ships. The Japanese have agreed, in principle, to such an arrangement. The Administration did not insist on U.S. construction of these ships despite the fact that our estimates show an impact of $25 per car for U.S. construction costs.

Since car carriers could be designed and built to serve U.S. defense sealift purposes, we believe that a portion of these U.S.-flag ships should be built in the United States. The defense features could be paid for by the Department of Defense through a civil reserve sealift assistance program similar to the program operated by the Air Force for civil airliners.

An opportunity exists through continuing negotiations with the Koreans, the Japanese and the U.S.-flag operators to allow for some of these ships to be built here.

c. Ship Design and Shipyard Management

The ability to design and engineer merchant ships is a vital part of America's defense mobilization base capability. The argument that the naval architects and marine engineers employed to design and build the 600-ship Navy provide this part of the base is false, because commercial ships are different from naval ships. Their missions and functions are different, and therefore, the underlying technologies and required design standards are different. Ship design organizations have separate engineering divisions to develop commercial and naval ship designs.

When naval architects and marine engineers are not designing commercial ships, their merchant ship design skills are diminished. If there is little or no commercial ship design done in this country over an extended period, then the nation will lose the capability to design sealift ships because designers cannot be retained when work load is unstable.

The unstable work load in the industry creates particular problems for design personnel. Yards with one program face the difficult decision of allocating their labor force as a program progresses. Normally, naval architects would proceed to the next project as the welders pick up the bulk of work on a ship. If there is no other work, does the yard release its labor?

There is no published data on the number of naval architects and marine engineers employed designing commercial ships at any given period of time. However, a quick survey indicates that the number of ship designers assigned to commercial-type ship design jobs in the mid-1980s is only about five percent of the corresponding number a decade ago in the mid-1970s. Of those few people working on commercial jobs, most are surviving on work which is not new merchant ship design. It is peripheral work such as specifying changes required to reflag foreign-built ships to U.S.-flag requirements or the design of sewage sludge barges.

There is also generalized concern about maintaining shipyard management teams in the face of declining work load. It will not be possible to manage the mobilization of American yards without trained and knowledgeable management. The Council would argue that the plight of ship designers, management, as well as skilled labor needs to be sustained and can be through the programs proposed. Our World War II performance not only relied on preplanned and early orders, but also on a committed, dedicated, and in-place management, engineering, and design capability.

d. Defense Procurement Policy

Another issue which should concern the Subcommittee is the impact of defense procurement policies on the financial health of the industry.

The shipbuilding industry has provided the Navy with a real success story through the cost savings generated in shipbuilding contract competition. To date, the industry has been able to deliver $5.3 billion in reductions to the Defense Department over the past six years. Competition has made it possible for shipyards to tighten internal cost controls, improve production processes, and generate significant gains in productivity.

Despite these endeavors, the Defense Department continues to seek further reductions in outlays by restricting progress payments, attempting to control profits, and delaying payment on properly identified invoices. Finally, there is also widespread industry concern that as fiscal controls escalate, there will be a corresponding delay in the provision of payments on negotiation of change orders and requests for equitable adjustment on non-shipyard variables that may affect ship delivery.

The Subcommittee should take note of these developments and how they will affect an industry, generally marked by weak conditions, from a financial point of view. Procurement policy is being made in a vacuum, with an eye toward short-term financial gain and no concern whatsoever for the impact those decisions will have on the defense industrial base.

Conclusions

The Congress has not repealed section 101 of the 1936 Merchant Marine Act. This section, which articulates the policy implications of the Act, remains the maritime policy of the United States.

It is apparent that the construction of ships, both naval and commercial, is consistent with the aims of the Act. The question is how to do it and we have proposed a number of potential programs to accomplish the maintenance of a sound and effective industry in support of defense and economic requirements.

It cannot be accomplished by a government hell-bent on dismantling the base either through the rejection of its role in maritime support or through the relentless pressure placed on shipyards in the naval ship procurement process. Government must establish what level of capability is needed, develop a policy to sustain it, and industry will perform. We understand that funding is not limitless but if nothing is done, we will witness the complete collapse of the industry and we believe that no one in a position of responsibility has made that decision.

We urge the Subcommittee to reverse the trend in the Government's abandonment of the shipbuilding industry.

This concludes my prepared statement. I will attempt to answer any questions you might have.

TODD PACIFIC SHIPYARDS CORPORATION
Seattle Division: P.O. Box 3806, Seattle, Washington 98124 Tel. 623-1635 (Area Code 206)

February 17, 1988

The Honorable Glenn M. Anderson
Acting Chairman - Subcommittee on Merchant Marine
U. S. House of Representatives
Longworth House Office Building - Room 1334
Washington, D.C. 20515-6230

Dear Congressman Anderson:

Pursuant to your January 19 request to respond to several questions in connection with the December 8, 1987, Oversight Hearing on Shipbuilding and Repair, I am pleased to offer the following comments.

The Honorable Mike Lowry (D-WA) asked:

1. AS A SHIPBUILDER, WHAT EFFECT DO YOU SEE GOVERNMENT POLICIES HAVING ON THE SHIPBUILDING INDUSTRY?

   The abandonment of the commercial sector of the private shipbuilding and ship repair industry by the government has directly caused a serious decline in facilities and skilled workers. Indeed, measured against a 1982 shipyard base of 110 facilities and 112,000 workers cited in a Navy study as marginally adequate for defense purposes, the industry has suffered a 37 percent decrease in the number of shipyards to 69 and a 29 percent reduction of workers to 80,000 in five short years. Absent a dramatic turnaround, I fully expect this attrition to continue.

2. ARE THERE PROBLEMS PARTICULAR TO THE WEST COAST, TO SEATTLE?

   Shipyards located on the West Coast in general and Seattle in particular have borne the brunt of the decline in facilities and manpower. This decline has been exacerbated by the completion of some Navy newbuilding and conversion programs on the West Coast, e.g., the FFG-7 (guided missile frigate) T-AH (hospital ship), and fast sealift ships.

3. WHAT NEW FEDERAL PROGRAMS OR POLICIES WOULD HELP THE SHIPBUILDING AND REPAIR INDUSTRY?

   Both the Commission on Merchant Marine and Defense and the Shipbuilders Council of America have made a number of specific recommendations to revive the shipbuilding and ship repair industry. Both fully support a "Procure and Charter" program under which the Transportation Department would construct in private yards "at least" 12 vessels a year for charter to private operators. These and other U.S.-built vessels would have access to the carriage of government and government-impelled cargo prior to foreign-built, U.S.-flag vessels. Both fully support an examination of the existing law governing the payment of duty on non-emergency repairs on U.S.-flag vessels in foreign shipyards to discover ways to carry out the original intent of Congress to foster a healthy domestic repair industry.

Should an expansion of the foregoing be required, please don't hesitate to contact me directly. I am always eager to help.

With best regards,

Sincerely,

H. K. Schaefer
General Manager

TESTIMONY OF D. F. SMITH, DIRECTOR OF MARKETING, BENDER SHIPBUILDING AND REPAIR CO., AND CHAIRMAN, AMERICAN WATERWAYS SHIPYARD CONFERENCE, BEFORE THE SUBCOMMITTEE ON MERCHANT MARINE, DECEMBER 8, 1987

Good afternoon Mr. Chairman and members of the subcommittee. My name is D.F. Smith, and I am Director of Marketing for Bender Shipbuilding and Repair Co., Inc., located in Mobile, Alabama. Bender Shipyard is a privately owned facility engaged in the repair of commercial, both inland and deep draft, and military vessels. Bender has a current employment level of 400.

I am appearing here today in my capacity as Chairman of the American Waterways Shipyard Conference, or AWSC. AWSC is a part of the American Waterways Operators, the national trade association for the barge and towing industry, inland and coastal. AWSC represents the small to medium sized or second tier commercial shipyards engaged in the construction and repair of vessels engaged in the barge and towing, offshore service and fishing industries. These same shipyards also undertake work on military vessels, both repair and new construction. We have a current membership of forty-seven shipyards located all around the country, and engaged in all types of shipbuilding and repair activities.

I appreciate the invitation to appear here today to discuss with you the decline of the shipbuilding and repair industry. The second tier shipyards, similar to our larger counterparts, have hit upon hard times. In 1986 alone, twenty-eight second tier shipyards closed their doors. The industry is in bad shape. If there is fault, we reckon it is shared by both the government and private sector. We overbuilt in the late seventies and early eighties in anticipation of increased export markets, the oil boom, and the attractive investment opportunities afforded individuals, due to ill advised, and now corrected, tax laws. Today, I would like to briefly describe the current state of our industry, however I will not dwell on our problems. We recognize that these problems exist, and we must work with them to stabilize our industry. But, more importantly, I would like to address areas where we, the members of the American Waterways Shipyard Conference, feel that you, as members of Congress, can be instrumental in helping the industry achieve this sense of stability once more. A strong shipbuilding industry profits this country in terms of both economics and national defense. The second tier shipyards have and continue to contribute to the shipyard mobilization base deemed necessary for our defense purposes. Economically, we provide work for, not only those employed directly in our shipbuilding facilities, but those employed in the related maritime supply sector. Although we appear small, we do exert a tremendous impact on our nation.

Unfortunately, the small to medium sized commercial shipbuilding industry hit bottom in 1982, and has yet to recover to the earlier heights of the late seventies. Some say it never will. In 1981, 3,600 vessels of all types were built, and by 1982, 1,500 vessels were built. Only 330 vessel were built last year. (1986 Annual Shipyard Survey, American Waterways Shipyard Conference, Arlington, Virginia.) New construction activity alone has declined by eighty-five percent between the years 1981 and 1986. There are a few commercial new construction contracts, but not at previous levels. Due to the nature of the marketplace, repair activity has stayed relatively constant, but many yards heretofore primarily dedicated to shipbuilding have had to shift to seek repair work. Therefore, there are more facilities competing for the same amount of repair work. The overall employment level for the second tier industry has dropped from a high of 50,000 in 1982, to a little over 10,000 in 1986, an eighty percent decline.

Our industry is recovering, but slowly, and at great cost. Since 1982, we have lost several major new construction shipyards: Jeffboat, Incorporated, Jeffersonville, Indiana; St. Louis Ship, St. Louis, Missouri; Dravo Marine Equipment Company, Pittsburgh, Pennsylvania; and U.S.S. Fabrication, Ambridge, Pennsylvania. We cannot even begin to list the number of smaller repair and new construction facilities which have closed their doors since 1981. To the best of our knowledge, 106 shipyards have ceased operations since 1981.

Unlike the closing of one of the larger shipyard facilities, the closing of a small yard does not attract national attention. However, the human suffering is just as profound, and the impact on our nation, in terms of economics and national defense. The closings not only represent a loss of skilled shipyard labor, but these closings also represent a dangerous reduction in the shipyard mobilization base deemed necessary for our nation's defense capabilities.

The Commission on Merchant Marine and Defense, in its first report entitled First Report of the Commission on Merchant Marine and Defense: Findings of Fact and Conclusion, states "Construction of the several hundred boats and craft required could be accomplished on the Great Lakes, on the inland waterways, and at the small and medium-sized shipyards. The ability to respond to small and medium-sized ship construction and repair requirements is considered sufficient both in 1987 and in 2000." We have serious concerns with this statement. Upon reviewing the list of shipyards which the Commission includes in its mobilization base, one sees listed repair facilities, but very few second tier shipyards with new construction capabilities. We are on the verge of loosing the capacity to quickly produce the necessary vessels via serial production. The yards which performed so admirably in previous war efforts are now closed. The majority of the new construction shipyards left are small and cannot employ serial production to quickly produce the vessels required. Jeffboat, Incorporated is the only major new construction facility which has the capacity to once again function as a working shipyard. All others have been sold or turned into other types of industrial activities, and their equipment has been lost to the industry.

The Commission further states, "Adequate ship building positions are not available to meet Navy or merchant marine new construction requirements during mobilization in either 1987 or 2000." This statement reflects the status of the large shipyards, however, the same is true of the smaller yards, many of which are considered a part of the mobilization base for the Commission's purposes.

The second tier shipyards also continue to make valuable contributions to this nation's economy by building and repairing the vessels utilized in the many diverse domestic trades. We are a "protected" industry. Protected by the Jones Act and other related cabotage provisions requiring U.S.-built, owned and crewed vessels. The second tier shipyards have never received subsidies from the federal government. We strongly believe that we can effectively compete with foreign shipyards on an equal playing field. We cannot effectively compete with foreign shipyards which are heavily subsidized by their respective governments. You must recognize that the world shipbuilding market does not operate under free market economics.

U.S. shipyards must comply with a strict regulatory regime designed to reduce pollution and raise the level of safety within the workplace which further adds to the cost of work in a U.S. shipyard. We recognize that it is more expensive to build a vessel in a U.S. shipyard than overseas, but it is due to the extra costs associated with government regulation, which we are willing to bear since it reflects the enlightened character and commitment of our nation to provide a decent work place, a clean environment, and a proper standard of living.

However, there are issues within the administrative and legislative realms which can be addressed resulting in benefits for the entire shipbuilding industry. I speak primarily of the necessity to modernize the Jones Act, the pivotal package of laws for our industry. The Act protects current markets, and its expansion offers new commercial market opportunities. I refer especially to the extension of the Jones Act requirements to beyond the three-mile limit which designates our territorial sea.

This entire discussion of legislative initiatives is, however, overshadowed by the current provisions of the maritime section of the recent Free Trade Agreement (FTA) reached by the United States and Canada. As we are all aware, this agreement allows Canadians equal access into any expanded Jones Act market. The Canadians will be allowed to utilize Canadian-built vessels and Canadian crews. U.S. operators will also be allowed to utilize Canadian-built vessels and Canadian crews in these expanded trades. The Administration, in adopting this maritime package, has adhered to its current policy of neither expanding or contracting the current Jones Act protections, however, in the process, this Administration has bargained away any future market opportunities for the small to medium sized commercial shipyards. We do not seek to rely solely on government contracts for our livelihood, but this FTA has the potential to do just that.

However, the most frightening provision of the maritime section of the FTA is the annual review process. Under this provision, there is no guarantee that the Jones Act, as it currently stands, will remain intact. Though commercial new construction activities are virtually non-existent, the inland and coastal fleets will have to be replaced as equipment deteriorates and as domestic activities increase. The towing association of Canada has already publicly expressed its displeasure with the maritime section because existing Jones Act trades have been grandfathered under the FTA. The FTA, as it is currently written, bargains away the smaller shipyards future commercial markets, and the inclusion of this annual review has the potential to bargain away our current market, if not the entire shipbuilding industry.

There are already certain circumstances where the coastwise laws apply to the operation of vessels between the United States and points on the Outer Continental Shelf (OCS), even though they are outside of the three-mile territorial zone. The Outer Continental Shelf Lands Act designates any object which is permanently embedded into the seabed as a point under the Jones Act. Therefore, all vessels servicing such points fall under Jones Act jurisdiction and must be U.S.-built. The question of what constitutes a "point" on the OCS has been continuously raised, through legislative and administrative discussions. Specifically, the application of the Jones Act to a mobile point within the OCS. We have long advocated the extension of the Jones Act to include those mobile points in the OCS over which the United States claims jurisdiction.

Recent legislation has been introduced by Rep. Mario Biaggi (D-NY) to further clarify the applicability of U.S. coastwise laws to mobile points within our Exclusive Economic Zone (EEZ). H.R. 82, a bill to amend the Merchant Marine Act of 1920 to require vessels transporting valueless materials to be built in the United States, was passed by the full House of Representatives on July 27, 1987. This legislation, as amended, would require the transportation of all types of valueless materials to points located within the EEZ in U.S.-built vessels. We commend Mr. Biaggi and the members of this subcommittee and full committee for the willingness to address in H.R. 82 the need to modernize U.S. cabotage laws to reflect evolving economic and technological activities. This legislation is a clear illustration of the need for legislative clarification of the term point. The points considered within H.R. 82 are not fixed, however, the United States has claimed jurisdiction over these areas for the purposes of the disposal of valueless materials. The City of New York, because of ambiguities in current law, contracted for four foreign-built barges to transport sewage sludge 106 miles offshore. Similar legislation has been introduced in the U.S. Senate by Sen. John B. Breaux (D-LA), however, the bill remains in committee. We have actively supported enactment of this legislation, and feel it is imperative that the U.S. Senate act quickly to resolve any outstanding issues surrounding this piece of legislation.

A succinct legislative clarification on the definition of "point" to include, not only fixed entities, but mobile entities as well within the OCS over which the U.S. claims jurisdiction will accomplish two objectives. One, it will help the U.S. Customs Service in determining the application of the Jones Act to these situations, and make their interpretations of the Act more consistent. And, two, it will provide new commercial opportunities for U.S. shipyards without providing direct government subsidies.

In addition, by providing a clear legislative definition of "point," the interpretations made by the U.S. Customs Service concerning Jones Act applicability will clearly reflect the market conditions of today. It must be noted that the Jones Act, when written in 1920, would decreasingly address future activities. The expansion of Jones Act requirements to objects permanently embedded in the OCS is a case in point. The Customs Service must rely on current law in their decisions, and a further clarification on the meaning of point within the OCS to mean any point over which the United States claims jurisdiction will help the Customs Service issue more definitive decisions over issues such as the use of foreign-built launch barges, floating warehouse ships, and the transportation of disposal material outside the three mile limit without having to resort to issue specific legislative initiatives.

Another Jones Act issue centers around the U.S. fishing industry. Loopholes exist within current law allowing foreign-built fish processing vessels to be re-flagged as U.S.-built vessels, thereby qualifying for full U.S. benefits under the Magnuson Fishery Conservation and Management Act. Another Jones Act loophole concerning the U.S. fishing industry concerns the practice of converting U.S.-built vessels in foreign shipyards for use in the domestic fishing industry. As you are aware, AWSC has been actively involved in a legislative effort to ban these re-flagging activities, and, more importantly, to prohibit these foreign conversions of U.S.-built vessels. No other domestic trade has the latitude, under current law, to undertake such extensive conversion projects. Up to ninety percent of the hull and superstructure are removed from these U.S.-built vessels, and they still retain the privilege to participate in the domestic trades.

The House of Representatives has favorably reported legislation, H.R. 2598, the Commercial Fishing Industry Vessel Anti-Reflagging Act of 1987, designed to stop both re-flagging and foreign conversion activities, and we urge early and favorable action in the U.S. Senate. This legislation will not only close a loophole in the Jones Act, but will ensure a stable market for our industry without threat of foreign subsidized competition.

Another issue directly related to the foreign conversions of U.S.-built vessels is the increasing occurrence of repairs in foreign shipyards of U.S.-built vessels engaged in domestic trades. As you are aware, the U.S. Customs Service levies a fifty percent duty on certain repairs, depending on whether they are classified as dutiable or non-dutiable. This fifty percent duty has always been a controversial item, and the Administration has sought to repeal it on several occasions. While we recognize that it is more expensive to have a vessel repaired in U.S. yards, it is depriving an already beleaguered industry. AWSC is in the process of alerting the U.S. Customs Service to this increased activity and requesting the agency to closely monitor these foreign repairs so that the duty can be accurately assessed.

This practice not only hurts the shipyard industry, but the associated marine supply industry. The further erosion of the shipbuilding industry, both large and small, points to an even greater problem -- the erosion, and potential disappearance of a maritime supply industry. Even today we are experiencing difficulties in obtaining the necessary supplies, steel, etc., from domestic sources. We prefer to use U.S. sources, however, the market dictates that we look to foreign sources for our supplies, at an increasingly alarming rate. It is not only the shipbuilding industry, as one of the last remaining industrial activities, which is in danger of extinction.

The legislative items previously mentioned are necessary to help ensure commercial markets for the shipbuilding and repair industry, but they will not cure the problem of the constantly shrinking shipyard mobilization base. The industry cannot rely solely on government contracts for new construction and repair contracts. The United States needs to make a concrete commitment to revitalize its merchant marine.

The Commission on Merchant Marine and Defense has publicly stated in its first report that the combined maritime industries are essential to our national defense, and in the long run, to the economic well being of our country. It behooves us to now plan for the continued existence of the shipbuilding industry. Yes, it will take government involvement, but the shipbuilding industry is a national asset in terms of defense preparedness. The most efficient way to protect our maritime interests is to maintain an active merchant marine -- U.S. built vessels engaged in foreign commerce manned by U.S. crews. Militarily useful ships in active trade would be a stronger resource than vessels idled in government reserve fleets. An active fleet would provide work for the shipbuilding industry, ensure a viable shipyard labor pool, maintain experienced U.S. mariners, and establish the United States as a strong maritime power once again.

Thank you, and I would be happy to answer any questions at this time.

Statement of Frank Drozak
President
Maritime Trades Department, AFL-CIO
Before the Subcommittee on Merchant Marine
Committee on Merchant Marine and Fisheries
U.S. House of Representatives
Washington, D.C.
December 8, 1987

My name is Frank Drozak. I am President of the Maritime Trades Department, AFL-CIO, representing 44 national and international unions with over 8 million workers. I appreciate this opportunity to comment on the reduction in U.S. shipbuilding and ship repair capability.

Mr. Chairman, the MTD has been before this subcommittee many times to decry the shameful decline of American shipbuilding and its implications for our economy and national security. There would be little point in repeating once again the long and distinguished role shipbuilding has played in our nation's history, up to the present decade.

Recent history, however, has been marked by political leaders turning their backs on the lessons of the past. As you know, Section 210 of the Merchant Marine Act of 1936 requires the creation and maintenance of efficient shipyards and repair capacity in the United States, with sufficient skilled personnel to provide an adequate mobilization base. During the last seven years, however, nothing has been done to implement or enforce the law as presently on the books, and no progress has been made toward forging the comprehensive, fair and workable national shipbuilding and maritime program that is so urgently needed.

Instead, the Administration has compromised its original pledge to revitalize the U.S. shipbuilding industry made during the 1980 presidential campaign and has, in fact, intentionally disregarded 50 years of maritime policy and law. The promises made in 1980 ring hollow when compared to the contradictory actions taken since that time, actions which terminated the construction-differential subsidy program, eliminated the Buy-American rule on ships built with Title XI loan guarantees. The Administration has repeatedly voiced its opposition to Buy-American provisions for offshore oil rigs and platforms on the Outer Continental Shelf, resulting in the elimination in conference of House amendments that would have significantly helped the shipbuilding industry.

Hostility to the continuation of the Title XI Ship Loan Guarantee Program figured in the decision to pocket veto the maritime authorization bill sent to the President by Congress just before it adjourned last year. Congress has fought back and thus far has successfully defeated the Administration's build-foreign program and its efforts to kill the Title XI program. In the case of the latter, the Title XI program exists in part precisely because of two otherwise incompatible principles: (1) American shipbuilders cannot build vessels at the same cost as foreign shipyards benefiting from massive subsidies, unfair trade practices and substandard wages; and, (2) our country's defense requires a shipyard mobilization base and skilled manpower pool adequate to meet national emergencies.

At the same time, the Administration supported legislation to permit subsidized operators to construct or acquire vessels in foreign countries for flagging in the United States, yet opposed legislation authorizing construction of merchant vessels in U.S. shipyards for naval and military sealift auxiliaries in times of national emergency. And, they have persistently refused to respond to congressional initiatives to address our inadequate shipbuilding capabilities.

Such flagrant policies have had a crippling effect on the U.S. domestic shipbuilding industry as well as its ability to maintain a mobilization base required for times of national emergency. The absence of positive Administration policies in the area of shipbuilding has fueled the continuous decline of the nation's shipyards and the erosion of the supply of skilled manpower in the shipbuilding industry. In our modern, interconnected economy, this has meant an aggravated decline in our overall industrial base, which in turn depends upon a healthy shipbuilding industry as a necessary alternative to relying on sole source suppliers and imports.

In 1980, there were approximately 135,000 shipyard workers employed in private yards. As of last year, there were fewer than 70,000 production workers employed in these yards. Of that number, 90 percent are employed on Navy projects. The last commercial deep-sea vessel was just delivered weeks ago, with none remaining on the order books. It is easy to anticipate what will happen to these shipyards and skilled manpower when the 600-ship Navy is attained and when no new orders are received in commercial yards for vessels in the foreign and domestic trades.

Another indication of how far the industry has sunk is evident in the just-released "First Report of the Commission on Merchant Marine and Defense: Findings of Fact and Conclusions", the latest in a series of reports that have projected dire straits for our shipbuilding capacity. Similar alarms have been sounded in the DOD Sealift Study (1984); the Shipyard Mobilization Base (SYMBA) Study (1984), jointly produced by the Navy and the Maritime Administration; the National Defense Shipyard (NADES) Study (1985), under the same joint sponsorship; and Shipping, Shipyards and Sealift: Issues of National Security and Federal Support (1985), by the National Advisory Committee on Oceans and Atmosphere.

While there is little in the latest report that is actually new, the image it describes is unrelentingly bleak. It notes that between 1982 and 1986, the shipbuilding and repair industry lost approximately 52,500 jobs, 76 shipyards and repair facilities, 22 building ways, 17 floating drydocks, 21 large graving docks and many plant facilities. At least 15 of the surviving firms are operating under Chapter 11 bankruptcy protection. The report further notes:

> The total collapse of commercial ship construction has been a major factor in the decline of United States shipbuilding capability. Government construction alone, mostly Navy and concentrated in a small number of shipyards, is insufficient to maintain a diversified shipbuilding and repair industry, including shipyard suppliers, sufficient to meet mobilization requirements in time of war or national emergency.... The shipbuilding mobilization base must be maintained to ensure that the demands of the national strategy can be met....
>
> Although the shipbuilding and repair industry would be able to meet the surge phase requirements during mobilization, the sustaining phase of mobilization would be constrained by shipyard facilities, manpower, and material supplier industries at different times in both 1987 and 2000. Adequate shipbuilding positions are not available to meet Navy or merchant marine new construction requirements during mobilization in either 1987 or 2000. Shipyard manpower is currently at a level that would constrain mobilization efforts beyond the surge phase, especially on the West Coast. Given current and projected capabilities, the shipyard supplier industries could not support mobilization new construction requirements in 1987 or in the year 2000.

Since 1982, the number of facilities identified as first-tier shipyards has declined from 110 to 74. This decline represents a 24 percent reduction in capacity over the past five years. This raises serious doubts over the ability of the nation as a whole to meet a large ship construction demand in a national emergency. American shipyards are an essential element of American seapower and national defense. Ways must be found to ensure their long-term viability.

With the almost total collapse of the domestic commercial shipbuilding market for foreign trade vessels and the near complete dependence on the Navy as the shipbuilding industry's prime customer, it is essential that a competitive commercial market be rekindled to ensure an adequate shipbuilding and ship repair mobilization base with an accompanying skilled labor force.

We must get back to basics. The depressed condition of the domestic shipbuilding industry can only be reversed by taking the following corrective actions:

- Establish a clear requirement for shipbuilding capacity for U.S. national security;
- Curtail U.S. Government contracts with foreign companies, both for supplies and research and development, which last year amounted to $9 billion worth of military contracts;
- Broaden the requirements of the Jones Act to cover all maritime activity within the 200-mile Exclusive Economic Zone;
- Initiate a government-sponsored build-and-charter program that would direct the government to build vessels to be chartered to commercial operators in peacetime, but would be subject to Navy recall during emergencies;
- Fully fund the Title XI ship construction loan and mortgage insurance program, the last remaining substantive shipbuilding support program, one that is essential for capital formation and fleet mobilization;
- Enforce and expand regulations requiring that Navy ship repair work be performed in U.S. shipyards; and,

- Replace sealift tankers serving the Navy's point-to-point oil requirements, whose capacity has been reduced by current regulations requiring a segregated ballast system.

Mr. Chairman, as always, the Maritime Trades Department remains committed to working with the Administration and Congress to seek a long-term solution to the continuing decline of the nation's commercial shipyards, with the goal of strengthening this basic element of our nation's defense structure.

STATEMENT FOR THE RECORD OF THE HONORABLE JOHN GAUGHAN, MARITIME ADMINISTRATOR OF THE DEPARTMENT OF TRANSPORTATION, AT THE OVERSIGHT HEARING HELD BY THE SUBCOMMITTEE ON MERCHANT MARINE OF THE HOUSE MERCHANT MARINE AND FISHERIES COMMITTEE ON THE REDUCTION IN U.S. SHIPBUILDING AND SHIP REPAIR CAPABILITY.

December 8, 1987

Mr. Chairman and Members of the Subcommittee on Merchant Marine, my name is John Gaughan, and I am the Maritime Administrator of the Department of Transportation. Pursuant to your request, I am pleased to submit this statement for the record setting forth the views of the Department concerning your Oversight Hearing on the reduction in U.S. shipbuilding and ship repair capability.

Mr. Chairman, I am in a unique position with respect to the subject of today's hearings, as I serve as Maritime Administrator, and have been appointed by the President to the Commission on Merchant Marine and Defense (Commission) which was established by Public Law 98-525, as amended. One element of the Commission's mandate was to study problems relating to the adequacy of the U.S. shipbuilding mobilization base to meet the needs of naval and merchant ship construction in time of war or national emergency. The First Report of the Commission on Merchant Marine and Defense: Findings of Fact and Conclusions was issued on September 30, 1987. Its findings and conclusions were endorsed by all seven members of the Commission.

Of particular interest for today's hearing are two of the Findings of Fact and Conclusions of the Commission which dealt with shipbuilding. The first was that "The total collapse of commercial ship construction has been a major factor in the decline of United States shipbuilding capability. Government construction alone, mostly Navy and concentrated in a small number of shipyards, is insufficient to maintain a diversified shipbuilding and repair industry, including shipyard suppliers, sufficient to meet mobilization requirements in time of war or national emergency." The second was that "The United States has become alarmingly dependent upon foreign sources of critical equipment, ranging from major propulsion system components to precision bearings, for Navy as well as for commercial ships. In some cases, the newest, most technologically advanced, and most important Navy weapons systems rely upon foreign manufactured components."

The Commission is now in the process of drafting recommendations for submission to the President and the Congress later this month.

In addition to my role on the Commission, I obviously serve as the Maritime Administrator. In that capacity I have continued the Administration policy of not funding the Construction-Differential Subsidy program for commercial ship construction in the United States. There is no question that such subsidies have failed to provide U.S.-flag operators construction parity with foreign operators over the past 30 years, during which time our shipyards have become progressively less competitive in international markets. As a result, we in the Administration strongly support the foreign construction of subsidized U.S.-flag merchant vessels for operation in our foreign commerce. Indeed, whether we continue to have a foreign trade merchant marine may very well depend on whether our subsidized operators can acquire their vessels at competitive world prices.

As Maritime Administrator, I will shortly participate in the Administration's review of the recommendations of the Commission. This review will attempt to balance the recommendations of the Commission with other competing demands upon the United States at this time. These competing demands are currently fiscal in nature, and I need not go into detail as to the severity of the problem. Whatever funds that will be available for our mutual efforts to promote the U.S. maritime industry must be allocated judiciously. We can not afford to repeat past mistakes.

Mr. Chairman, as Administrator and Commission member, I have been in the fortunate position of acquiring the most up-to-date information on the problems of the U.S. maritime industry. In my opinion, the completion and presentation of the Commission recommendations would be the appropriate starting point to assess what actions should be taken by the Administration and private industry to deal with the current reduction in U.S. shipbuilding and ship repair capability.

Mr. Chairman, I appreciate this opportunity to present this statement for the record at your Oversight Hearing on the reduction in U.S. shipbuilding and ship repair capability.

record

RECORD STATEMENT BY THE LOS ANGELES-LONG BEACH HARBOR REPAIR COUNCIL BEFORE THE SUBCOMMITTEE ON MERCHANT MARINE, ON THE REDUCTION IN U.S. SHIPBUILDING AND SHIP REPAIR CAPABILITY -- DECEMBER 8, 1987

The Los Angeles-Long Beach Harbor Repair Council is a newly formed and chartered non-profit organization. Its primary purpose is to promote waterfront business in the Los Angeles-Long Beach area for the benefit of its members, most of whom are small businesses which are trying to survive in an industry that supports the maintenance and repair of commercial and naval ships and craft. These include shipyards, boat repair shops, machine shops, electrical repair shops and supply companies of every nature.

These businesses, which for fifty years flourished around the shipping and fishing fleets in the Los Angeles-Long Beach harbor, are falling victim to the convulsive changes taking place on the waterfront as a result of our nation's trade-oriented economy.

There is no single culprit causing this situation; rather there are conditions which are out of balance. Some of these imbalances center on the following points:

1. Land Use of the Port Areas. Businesses are being forced to give up their waterfront spaces in favor of container storage and parking areas for imported cars, causing some businesses to close their doors for good.

The modernization of the ports has not looked to balancing the needs for pier space among the industries which have competed for and used the space in the past. Goods storage is overtaking almost all other uses of the harbor area, including manufacturing. With imports expected to increase four-fold in the Los Angeles-Long Beach harbor area over the next twenty years, the businesses represented by this Council are sure to fail unless recognition is given to the importance of balancing waterfront land use.

2. Dock Space. There is a tremendous increase in the number of ships doing business in the Ports of Los Angeles and Long Beach. However, the competition for pier space prevents its use by ships wishing to tie up for repairs. Thus, the foreign ships that now dominate the shipping business are unable to gain access to our repair facilities. So they wait until they arrive at another port, ususally in another country, to seek their repairs.

3. Merchant Fleets. The shipping fleets that once carried the U.S. Flag have diminished significantly over the past twenty years. The laws that regulate the shipping industry are too restrictive to allow for competition with foreign fleets. With the change of flag has come a change of crew and business patterns throughout the industry.

The impact of this change has been felt on the waterfronts of America. Twenty years ago, ship and boat repair activity in the Los Angeles-Long Beach area consistedly mostly of work on commercial vessels. As our merchant fleet continues to shrink, these yards are depending more and more on naval ship repair work to stay in business. And unless these small yards get a fair share of the Navy market our nation's ship repair capability will erode even further.

We commend the subcommittee for holding this hearing to learn first hand about the problems facing the shipbuilding and ship repair industries. Hopefully, legislation can be formulated and passed to help our industry overcome some of these problems.

The Council deeply appreciates the chairman's invitation to express our views through the submission of this statement for the record

(Paul Tsompanos, 11 Carriage House Circle, Alexandria, Virginia 22304)

RECORD STATEMENT OF PAUL J. BURNSKY, PRESIDENT, METAL TRADES DEPARTMENT, AFL-CIO, BEFORE THE SUBCOMMITTEE ON MERCHANT MARINE ON THE REDUCTION IN U.S. SHIPBUILDING AND SHIP REPAIR CAPABILITY -- DECEMBER 8, 1987

Thank you for the opportunity to present these views, Mr. Chairman, on behalf of the Metal Trades Department, AFL-CIO and its 21 affiliated unions with some 5 million members. Many of them work in defense-related jobs associated with the construction, repair, and maintenance of Navy combat vessels in large private shipyards and in our U. S. Naval Shipyards.

We commend you, Mr. Chairman, and this subcommittee for holding this timely oversight hearing on the alarming decline of the American shipbuilding and ship repair industry. There can be no legitimate argument against the fundamental conclusion that a strong, economically viable shipbuilding industrial base is not only essential to U. S. maritime survival, but also vital to our national defense.

Since the Metal Trades Department has been so closely involved with the American shipbuilding and repair industry since our founding almost 80 years ago, we have seen many early indications of the dangerous erosion taking place over the past decade. Employment in private shipyards has plummeted, particularly during the past 7 years. More than 30 shipyards have gone out of business. Less than 70,000 production workers now work in U. S. yards, little more than half the total number in 1980, and about 90 percent of the current number are engaged in Navy projects. Not one commercial vessel is currently under construction in any U. S. shipyard. Critical highly skilled types of craftsmen essential to construction of commercial and combat ships are being lost to the industry. Irreplaceable shipbuilding facilities are being lost to unrelated commercial development. The shipbuilding supplier industry has been decimated.

During this period of shipbuilding decline, the Department has issued endless numbers of warnings of the serious consequences -- in public statements, in Congressional testimony, in communications with the White House, the Defense Department, the Maritime Administration, with various "study" commissions, and in meetings with industry and public officials. Our biennial National Shipbuilding Conferences have pinpointed the basic causes of such deterioration of the shipbuilding industrial base and recommended specific legislative and administrative actions to reverse the trend. Delegates to our Metal Trades conventions have adopted clearly-worded resolutions advocating a series of remedial policies that are urgently needed if we are to remain a world maritime power. Such policies have been formally transmitted to Executive branch officials responsible for maritime policy making and to the Congress. But unfortunately, these early warning efforts -- like those of the shipbuilding and repair industry -- have been largely unheeded and the situation has continued to worsen. Initial findings of the Commission on Merchant Marine & Defense -- the so-called Bennett Commission-- in its September 30, 1987 report document the alarms sounded by our Metal Trades Department, the shipbuilding and repair industry, and other experts. These findings have been presented to the subcommittee in testimony by Dr. Allan W. Cameron, Executive Director of that Commission, and will not be repeated here. The Department had testified before the Bennett Commission last May and presented a broad range of suggested actions to strengthen our shipbuilding posture at both private yards and Naval shipyards.

Mr. Chairman, it is obvious that no country can maintain a viable shipbuilding industrial base today without a strong commitment by its national government. This means subsidies of one kind or another because there is no such thing as a "free market" in world shipbuilding. But the Reagan Administration, despite its glowing 1980 campaign promises to revitalize the American shipbuilding and maritime industry, has systematically violated or ignored the basic maritime laws passed by Congress many years ago to assure a viable U. S. shipbuilding and repair industrial base and a modern, efficient U. S. merchant marine.

Fuzzy-minded Administration idealogues who have framed the Reagan maritime policies have done more to help cripple the U. S. shipubilding industry than all the Kremlin could hope to accomplish. These Administration "amateur mariners" and their text book economic theories are responsible for the Administration decisions that quickly killed the time-tested Construction Differential Subsidy (CDS) program to aid U. S. shipyards to fulfill their commitments. It was not some Soviet agent, or the Japanese MITI that has been pushing the Reagan Administration's insane "build foreign" shipbuilding program that would terminate the American shipbuilding industrial base with "extreme prejudice," it has been these same Administration bureaucrats.

Foreign saboteurs didn't try to kill the Title XI ship loan guarantee program or successfully eliminate the "Buy American" provisions of that program, or undermine the Jones Act -- it was these same faceless Administration appointees at OMB, MARAD, and the White House who must bear that responsibility. It is significant that no such witnesses are here to defend those ill-conceived, damaging policies before this subcommittee today.

The fact is that the Reagan Administration -- despite its many promises -- has failed to propose to Congress a realistic national shipbuilding and maritime program. Its lack of any coordinated economic, foreign trade, defense and foreign policy objectives has led to our Nation's largest trade deficit, our record national debt, the bankruptcy of hundreds of thousands of small and medium-sized American businesses, the loss of more than 2 million industrial jobs, and the dangerous overdependence of our national defense effort on foreign-based suppliers.

Mr. Chairman, there is an urgent need to undertake new policies and to begin new programs that will upgrade American shipyards, modernize our shipbuilding technology, and preserve the dwindling supply of skilled manpower. We must also shore up the U.S. shipbuilding supply industrial complex. Approximately two-thirds of the dollars used in U. S. warship construction are spent outside the shipyard. Alarming amounts of such supplier parts and components of our Navy combatant vessels are being procured from overseas industrial sources. It is ironic that post-World War II economic and technological assistance was provided by U. S. taxpayers to devastated foreign countries has now resulted in more modern and efficient manufacturing facilities than those enjoyed by U. S. companies. America's basic "smokestack" industries -- steel plants, machine shops, foundries, shipyards, and similar facilities vital to our national economic health and our national defense have been hard-hit by unfair global competition.

Modernization of U. S. shipyards will require Federal tax incentives to permit the introduction of new machinery and equipment, innovating plant design and layout, and other similar technological improvements to make them more efficient. Without government maritime policies that provide the opportunity for commercial ship construction in this country, shipyard owners cannot accomplish these vital objectives without help. The Metal Trades Department strongly supports the efforts of shipyard management to modernize their facilities and to more efficient and productive. We have encouraged technological change that will aid U. S. shipyards to work toward these goals and for the most part, labor-management cooperation in shipyards at which Metal Trades Councils are the collective bargaining agents has been positive and constructive.

We are also gravely concerned, Mr. Chairman, over the erosion of the supply of skilled manpower in the shipbuilding and repair industries -- both at private yards and Navy yards. The shipyard workforce is aging, particularly at the more skilled journeyman level, and fewer young people are choosing to enter an industry where future job security is uncertain. Layoffs of significant numbers of skilled shipbuilding craftsmen over the past several years has forced many thousands to abandon shipyard employment for more stable jobs in their skill area. This raises serious doubt as to our ability to meet a large ship construction demand in any national emergency.

Again, we appreciate the subcommittee's leadership in holding these hearings and pledge our cooperation in efforts to initiate remedial legislative action to correct the dangerous erosion of the shipbuilding industrial base in the United States and to restore our maritime leadership in the world.

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December 9, 1987

U.S. House of Representatives
Committee on
Merchant Marine and Fisheries
Room 1334 Longworth House Office Building
Washington, D.C. 20515-6230

Mr. Chairman, members of the committee, thank you for the opportunity to submit testimony to these proceedings.

For the record, my name is Thomas F. Lewiston 2822 253rd Place S.E. Issaquah, Wa. 98027 ph:(206)392-5577.

I was a 21 year employee of Lockheed Shipbuilding Co. of Seattle, Wa. On 17 November 1986 along with 684 of my fellow workers was locked out from our jobs. Many of us believe the lockout was in part caused by the procurement policy of the U.S. Navy which has created an atomsphere of cutthroat low ball bidding by contractors to secure Navy business. With virtually no merchant ships under construction the Navy has become the only source of business.

Since 1985, over 8,000 skilled workers have been displaced from the Puget Sound Shipbuilding industry with more expected as the decline of the industry continues. The loss of this valuable labor pool which has taken generations to build could be devastating to the national security of our country.

As the primary shipyards have declined we have also witnessed plant closures and mass layoffs in associated supplier industries on the local and national level. Locally the Square D Manufacturing Co., and Leckenby Steel have closed as a direct result of the decline in shipbuilding. On a larger scale we can look at the devastation in one of our most basic industries, steel, a primary component of shipbuilding. More recently " Babcock and Wilcox has announced that, effective 31 December 1987, they will cease all production of tubing, including that for which they are sole source. This will leave shipbuilding without a domestic source for cold drawn seamless tubing of 4 inch and above". It is apparent that the decline in shipbuilding is having a broad systemic impact on related industries.

The solution to the problem may be as varied as the number of plant closures and layoffs but from a worker's perspective I would offer the following:

1. Change the Navy procurement policy that puts all emphasis on "buy cheap". Ofen times this has proven erroneous with the contractor submitting cost recovery claims to recover revenue because of a "low ball" bid.
2. Restoration of the Construction Differential Subsidy. While every other shipbuilding nation in the world subsidizes its merchant ship production we have chosen to abandon ours.
3. Launch a shipbuilding program to replace our aging merchant fleet.

4. Develop a national industrial policy to examine and make recommendations to halt the decline of our basic industries.

American shipbuilding is an integral component of our industrial, economic and international trade history and character of this once great industrial nation. In 1976 our bicentennial celebrated 200 years of liberty that was symbolized by the "tall ships" and the significant contribution of a maritime fleet. The role of the maritime is no less significant today. Will this country last another 100 years if we don't act to revitalize this essential basic industry? We impatiently await the results of your deliberations and look to you for leadership in this crisis.

Thomas F. Lewiston

THOMAS F. LEWISTON

GAO

United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-228619

October 16, 1987

The Honorable Bill Chappell, Jr.
Chairman, Subcommittee on Defense
Committee on Appropriations
House of Representatives

Dear Mr. Chairman:

This report responds to your December 30, 1986, letter concerning the effects of increased competition for Navy ship construction contracts. On April 23, 1987, we testified before your Subcommittee on the preliminary results of our work. This report updates and expands on the information provided and observations made at the hearing.

As requested, we have reviewed selected shipbuilding contracts awarded over the past few years to determine (1) whether these contracts can be executed within the funding appropriated, (2) the status of current and future claims against the government, (3) the actions that the Navy is taking to address current and anticipated claims, and (4) whether current staffing levels at Navy Supervisor of Shipbuilding, Conversion and Repair (SUPSHIP) activities are providing effective oversight over the contracts.

We found that the Navy has realized favorable bid prices from increased competition for its shipbuilding contracts. However, our review of 22 competed contracts shows the Navy is currently projecting cost overruns of about $1.413 billion over target costs on 19 contracts. The Navy is required to pay at least half of these overruns (about $706 million) up to a maximum ceiling price.

The Navy, in most cases, has sufficient program account funds to cover the Navy portion of the cost overruns. For a few programs, the Navy anticipates submitting reprogramming requests to cover its share of estimated overruns — $19 million for the fiscal year 1985 T-AO fleet oiler program, $10.4 million for the fiscal year 1986 T-AO program, and $30 million for the fiscal year 1984 FFG frigate program.

The causes for the overruns are many and varied, but most result from shipbuilders' decisions to cut prices and to make low competitive offers to obtain Navy contracts. This highly competitive bidding appears to be continuing on more recent awards.

It has been well established by Comptroller General decisions that an offeror can choose to cut prices for competitive purposes. As long as the proposal is technically acceptable, fair and reasonable in terms of price, and the contractor has been determined to be responsible to do the work, the contract award may be made to that offeror. The contracting officer must, however, assure that change orders or follow-on contracts are not used to recover amounts of below-cost bids.

Our analysis of cost overrun projections indicates that certain trends are developing that, if continued, could have future cost implications for both the shipbuilders and the Navy. Cost overruns on some contracts are increasing at a significant rate and are near, at, or above the ceiling price where the Navy's sharing of overruns ends, and the contractors are expected to lose money.

Historically, when shipbuilders experienced or were about to experience losses on contracts, they attempted to recoup the losses through claims against the government. Our analysis of the Navy's quarterly reports on Requests for Equitable Adjustment and claims and anticipated submissions indicates that the Navy will soon be facing increased activity in this area.

There is an overall awareness within the Naval Sea Systems Command (NAVSEA) of the necessity to avoid claims. Policy and procedures for minimizing the occurrence of claims and, if necessary, for resolving claims have been implemented; training and feedback on lessons-learned are being provided to SUPSHIPS; and programs directed to avoiding claims are in place at SUPSHIPS. These programs are periodically assessed by headquarters/field review teams during management reviews at each SUPSHIP. The most recent of these reviews did not indicate any major problems with the programs, other than isolated instances of insufficient staffings.

Five of the eight SUPSHIP activities we visited felt their staffing levels were inadequate to carry out oversight functions. However, we determined that NAVSEA, during mid-year and third quarter fund redistributions in March and June 1987, had authorized additional staff that appeared to meet most of the SUPSHIPS' stated needs.

As requested, we also interviewed representatives of major shipbuilders to obtain their views on contract award issues. They confirmed that shipyards are bidding low because of the current market environment and, in some cases, to survive. However, they were generally concerned about the long-term effect of using the lowest price as the driving factor in contract awards.

Conclusions

Over the past few years, the U.S. shipbuilding industry, faced with a weak and declining commercial market, has been intensely competing for limited Navy ship construction work. As shown in this report, highly-competitive bidding on Navy contracts is producing cost overruns of a magnitude that could present future problems to shipbuilders and the Navy. Past experience suggests that severe financial difficulties by shipbuilders on Navy contracts resulted in large claims against the government. We believe the developing trends associated with cost overruns and claims on Navy contracts need to be carefully monitored.

As requested, we did not obtain official comments on our report. We did obtain the views of agency officials from individual contract and program offices. Their views are included where appropriate.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies to interested committees and other members of the Congress, and the Secretaries of Defense and the Navy. Copies will also be made available to other parties upon request.

Sincerely yours,

Frank C Conahan

Frank C. Conahan
Assistant Comptroller General

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Abbreviations

GAO	General Accounting Office
NAVSEA	Naval Sea Systems Command
REA	Request for Equitable Adjustment
SUPSHIP	Supervisor of Shipbuilding, Conversion and Repair

Cost Overruns and Claims Potential on Navy Shipbuilding Contracts

Over the past few years, the U.S. shipbuilding industry has experienced a weak and declining commercial market. As a result, the industry has become almost completely dependent on the Navy as a primary customer and competition for Navy work has become extremely intense.

Within this environment, the Navy has awarded contracts based on policies that increased the levels of competition, placed more emphasis and relative importance on price in the evaluation of bid proposals, and expanded the use of fixed-price incentive contracts containing equal sharing provisions of cost risk. According to the Navy, the increased competition and emphasis on price have generally resulted in favorable contract prices and, in some cases, declining unit prices on ship programs. On the other hand, low prices realized from aggressive, competitive bidding could present future cost and other problems to the Navy, as financially troubled shipyards try to recoup losses when they become unable to keep costs at or below the agreed level.

On December 30, 1986, the Chairman of the Subcommittee on Defense, House Committee on Appropriations, requested that we review shipbuilding contracts awarded over the past 3 years. The Chairman referred to the positive aspects of increased competition, but also noted that there were indications that current contract awards could result in future claims against the government.

Objectives, Scope, and Methodology

Our objectives were to determine (1) whether contracts awarded could be executed within the funding appropriated, (2) the status of current and future claims against the government, (3) the actions that the Navy is taking to address current and anticipated claims, and (4) whether current staffing levels at the Supervisor of Shipbuilding, Conversion and Repair (SUPSHIP) activities are providing effective oversight over the contractors.

We reviewed the competitive award of 22 fixed-price incentive contracts and these contracts' financial and construction status. The contracts covered 9 combatant and noncombatant ship programs at 10 private shipyards and were the most recent contracts on which work had started or was recently completed. Our selection covered most contracts awarded since fiscal year 1983 and included some earlier 1981 and 1982 awards. In connection with reviewing the potential for future claims, we also examined additional contracts which were recently awarded.

Our work was performed at eight SUPSHIPS that were administering the contracts — Bath, Maine; Groton, Connecticut; Long Beach, California; Newport News, Virginia; New Orleans, Louisiana; Pascagoula, Mississippi; Portsmouth, Virginia; and San Diego, California. We also performed work at contract, program, budget, and SUPSHIP oversight offices of the Naval Sea Systems Command (NAVSEA) in Arlington, Virginia.

At the SUPSHIPS, we obtained information on and discussed the contract cost, schedule, and construction performance; estimates of cost at completion; claims avoidance programs; claims potential; contract adjustment and claims submissions; and staffing levels.

At NAVSEA, we obtained information on and discussed claims reporting and policy, staff resource determination and monitoring, and contract policy. We reviewed Business Clearance Memoranda[1] associated with selected contract awards. We also reviewed claims avoidance assessments resulting from NAVSEA management reviews. In addition, we analyzed and discussed program funds with Comptroller officials, and interviewed representatives of five major shipbuilders to obtain their views on contract issues.

We developed information on causes of cost overruns through discussions with officials, an analysis of information at Navy contract administration activities, and Navy analyses of contractor proposals.

Our review was performed between February and July 1987 and was conducted in accordance with generally accepted government auditing standards.

Cost Overruns Exceed Underruns by Wide Margin

While the Navy may be realizing declining shipbuilding contract prices, our review of the status of 22 fixed-price incentive contracts awarded since about 1982 shows that the Navy is projecting target cost overruns on 19 of them. These projected overruns total about $1.413 billion, up 18.3 percent from the $1.194 billion overrun on 17 contracts reported during our April 1987 testimony. The remaining three contracts had underrun projections totaling about $25.9 million, down considerably from the $59.8 million in estimated underruns on five contracts reported in April.

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[1] The Memoranda are records documenting the bases for and approval of all contractual actions associated with a contract award.

Eighty-two percent of the $1.413 billion overrun involves three ship programs — 55 percent on the SSN-688 submarine, 16 percent on the Aegis cruiser, and 11 percent on the LHD assault ship programs. The four major shipyards holding the majority of Navy shipbuilding contracts account for about 87 percent of the total overrun.

A schedule of the contract cost projections is provided in a proprietary supplement, GAO/NSIAD-88-15S.

Sufficiency of Program Funds to Cover Navy Portion of Overrun

Fixed-price incentive contracts contain provisions for the sharing of cost overruns up to a ceiling price. Amounts above the ceiling price are borne entirely by the contractor. On the contracts reviewed, if final costs come in at the current estimates at completion, the Navy's share of the projected overruns would be about $706 million.

Our analysis of program funds and discussions with NAVSEA Comptroller officials indicate that there will be sufficient funds to cover anticipated cost overruns. According to the Navy, funds are sufficient to cover the Navy's estimated portion of cost overruns in most of its programs. In some programs, such as the SSN-688 attack submarine, the CG Aegis cruiser, and the landing craft air cushion vessel, the Navy has increased the basic construction line item cost by moving funds from other lines within the program account to cover anticipated cost overruns. In addition, the Navy expects to submit reprogramming requests to cover its share of estimated overruns of $19 million for the fiscal year 1985 T-AO fleet oiler program, $10.4 million for the fiscal year 1986 T-AO program, and $30 million for the fiscal year 1984 FFG frigate program.

Causes of Overruns

The causes for the projected overruns are many and varied. On some contracts, shipbuilders are experiencing labor productivity problems and shipyard inefficiencies; on others, some shipyards, according to the Navy, have underestimated the complexity of construction. Certain contracts are being affected by problems external to the shipyard, such as a large amount of design changes and late government-furnished equipment and data.

The shipyards' decisions to cut prices (in some cases, below expected costs) to make low competitive offers and obtain Navy contracts appear to be the major contributor to the overruns. For example, successful offers on Aegis cruiser contracts at Bath Iron Works, according to Navy analyses, included overly optimistic learning curves. We previously reported[2] that Electric Boat's fiscal year 1986 contract price for SSN-688 submarines was understated and did not reflect contractor estimates that indicated that the construction cost was likely to be higher. Six months after the award, the Navy was forecasting a cost overrun of $196.1 million. Cost evaluation and price analysis reports associated with the Navy's review of proposed prices on some other contracts contained references to aggressive labor hour reductions and optimistic estimating by successful offerors.

Our examination of 2 recent awards not among the 22 contracts reviewed shows that the Navy may be facing additional cost overruns because of significant reductions in proposed cost by the offerors. Navy analyses indicate that both contracts were awarded at a substantial cost risk to the government based on comparisons of the proposed prices with the Navy's estimates. In both of these awards, the Navy believes that there is a strong possibility that the contractors will exceed ceiling prices.

Two other recent awards further illustrate aggressive price competition. The fiscal year 1987 SSN-688 submarine contract for all four ships was awarded at a price that was $4 million lower than the previous year's for a similar quantity, and the DDG-52 Aegis destroyer follow-ship award to a second-source contractor was about 25 percent under the lead-ship price.

Shipbuilders' Views

Our interviews with shipbuilders confirmed that the industry is currently competing in a "low ball" or close to the margin environment on Navy ship construction contracts. Some stated that yards will continue to bid low for limited Navy work to survive, but that certain successful bidders might not survive because of huge overruns they cannot absorb. They believed this would especially apply if follow-on contracts were not obtained to help recovery from a low bid.

Some shipbuilders believe bids are low because too many shipyards are pursuing less work. Shipyards are going out of business, and those remaining bid dramatically lower prices to stay in business. One shipbuilder said the Navy has sent a message that ship contracts will be awarded based on price and the response has been to bid aggressively.

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[2] Navy Contracting: Fiscal Year 1986 Contract Award for Construction of SSN-688 Submarines (GAO/NSIAD-87-120, May 4,1987).

There was concern about the long-term effect of using the lowest price as the driving factor in contract awards. One shipbuilder said that more weight should be placed on realism during the evaluation of proposals and that the Navy should consider the shipbuilders' supply base, financial ability, technical competence and capability, and the long-term consequence of losing a reliable contractor because of a low bid.

Federal Procurement Regulations Do Not Prohibit Low Bid Proposals

It is well established under Comptroller General decisions that an offeror can choose to cut its price for competitive purposes. As long as the proposal is technically acceptable and fair and reasonable in terms of price, and the contractor has been determined to be responsible to perform the work, a contract award may be made to that offeror. The contracting officer must, however, assure that change orders or follow-on contracts are not used to recover from below-cost bids.

To be determined responsible, a prospective contractor must meet certain prescribed financial, performance, managerial, and business standards contained in Part 9, Contractor Qualifications, of the Federal Acquisition Regulation. Some of the elements of responsibility require that the contractor have adequate financial resources to perform the contract; a satisfactory performance record; and the necessary production, construction, and technical equipment and facilities, or the ability to obtain them.

Although price was the highest weighted factor in all of the procurements we reviewed, the Navy, in its evaluations of the offers, considered other technical and managerial factors. Where necessary, pre-award surveys were performed, and in each case, a determination of contractor responsibility was made.

Moreover, in evaluating proposals Navy acquisition officials can and do consider national defense and industrial mobilization base as a factor. The use of this factor reflects an acquisition office's recognition of the need to effect an award pattern that best promotes the interest of national defense and industrial mobilization in accordance with federal procurement law. This determination allows the Navy, for example, to prevent a key shipyard from going out of business by awarding it a contract for industrial base purposes. We found that split awards were made for these purposes in the Aegis cruiser and nuclear attack submarine programs.

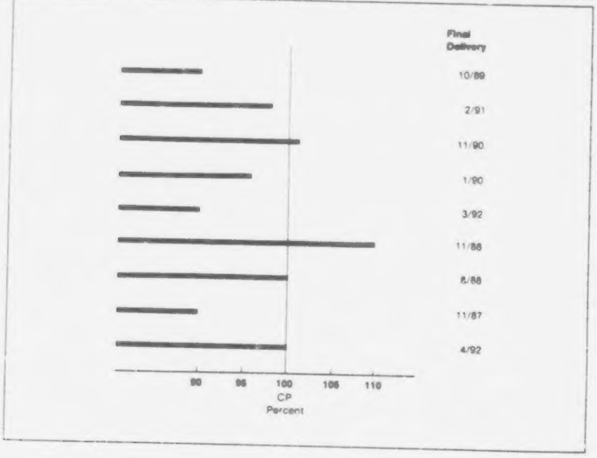
Overrun Trends and Cost Implications

Our analysis of cost overrun projections indicates significant trends are developing that, if continued, could have future cost implications for the Navy and the contractors.

For some shipyards, cost overruns are increasing substantially in amount on each succeeding contract awarded. Overruns have nearly doubled on each SSN-688 contract awarded since fiscal year 1981.

For these and other shipyards, many of the estimated costs at completion are near, at, or above contract ceiling price, where the Navy's sharing of increased costs over target ends and the contract is at a break-even point. Cost projections above this ceiling mean the contract is in an estimated loss position. In this regard, nine contracts have estimates at completion of at least 90 percent of ceiling price, four are projected at or above ceiling price. For the shipyards involved in SSN-688 construction, the more recent the contract, the closer it is to the ceiling price. Most of the nine contracts have a substantial amount of work remaining until final delivery, thus increasing the likelihood that the ceiling price will be exceeded. (See figure I.1.)

Figure I.1: Estimated Costs at Completion as a Percentage of Ceiling Price (CP)



Historically, claims have been made against the government primarily because a shipbuilder discovered that it was in a loss position or was approaching such a position. In the Naval Ship Procurement Process Study of the late 1970s, a study team's appraisal of lessons learned from an analysis of the 1970's claims situation showed that the Navy suffers from unrealistic prices in the long run since shipbuilders facing losses on contracts are likely to submit claims. The team observed that evidence of varying degrees of fault on the part of the Navy gave impetus to such claims.

Contract Adjustments and Claims Are Increasing

Our analysis of Requests for Equitable Adjustment (REA) and claims reported to NAVSEA by the SUPSHIPS and recent and anticipated submissions indicates that the Navy will be facing increased activity in this area. An REA is a request for payment, extension of the delivery schedule, or both, which is not in dispute at the time the government receives it. Whenever such a request cannot be settled by an agreement, the contractor may file a claim.

SUPSHIP records and quarterly reports on active REAS and claims relating solely or partly to ship construction contracts showed 10 submissions valued at about $200.9 million, as of December 31, 1986. The overall total increased to 28 submissions valued at about $345.4 million as of July 1987. All of these submissions are being reviewed by the Navy.

Among the submissions was a Bath Iron Works' REA that was initially submitted in November 1986 to recover cost overruns on three Aegis cruiser contracts. The REA noted that Bath Iron Works and the Navy's projected cost on the program had changed for many reasons, including government changes, delay, disruption, shipyard strike, and shipyard performance problems. According to the REA, both parties needed to reestablish cost, schedule, and technical baselines. Bath Iron Works computed and requested a proposed contract adjustment of about $100 million. In December 1986, Bath Iron Works, responding to a Navy request, provided additional supporting data to facilitate the Navy's analysis of the REA.

On May 18, 1987, Bath Iron Works submitted a revised REA that completely replaced the November 1986 submission. The contractor is now requesting a contract adjustment of about $134 million.

As we testified in April, Bath Iron Works also believes that it is entitled to additional compensation on the DDG-51 Aegis destroyer contract. The contractor said it will seek this compensation through an REA or the conventional change process.

Also among the active REAs was one submitted by the Electric Boat Division of General Dynamics Corporation on July 17, 1987, for cost adjustments of about $97.1 million and for schedule adjustments on two SSN-688 contracts. The REA is based on the impact of formal and constructive changes (untimely and defective data) for the design of the AN/BSY-1(V) combat system, retractable bow planes, and the placement of lead ballast.

Our REA/claim analysis also showed that:

- REAs and claims were submitted or are anticipated on 8 of the 19 contracts currently projecting cost overruns.
- One claim was submitted on one of the three contracts with projected cost underruns and was settled for the full amount requested — $1.5 million.
- Some of the characteristics of and circumstances that gave rise to the major shipbuilding claims of the 1970s are appearing on the larger REA/claim submissions. These include government changes, defective drawings or specifications, delay in government-furnished equipment or information, lack of or late design data, and program delay and disruption.

Actions Taken to Address Claims

There is concern and awareness within NAVSEA of the need to avoid claims on ship contracts. NAVSEA has policies and procedures to minimize the occurrence of claims and, if necessary, to resolve them.

These measures are directed to and are implemented by naval activities, such as SUPSHIPS, which are expected to experience claims situations. Each SUPSHIP we visited had implemented claims avoidance programs and some had issued local guidance that addressed the problem. The Navy's contract administration manual for ship acquisition also discusses claims management and related matters.

An important aspect of claims avoidance programs is the documentation of significant contract events. The rationale for this process is that adequate documentation is the key to the government's ability to verify, qualify, or refute contractor claims.

A NAVSEA headquarters office in the Contracts Directorate provides assistance and guidance to SUPSHIPS on claims matters. This office compiles statistics on REAs and claims from quarterly reports submitted by SUPSHIPS, supplies feedback on lessons learned from prior claims, provides training in claims avoidance, is involved in the processing of claims, and conducts contract management reviews once every 3 years at each SUPSHIP. These reviews include examining actions taken by the SUPSHIPS to avoid claims. SUPSHIP Operations Review Teams from NAVSEA's Industrial and Facilities Management Directorate also look at claims avoidance programs during their SUPSHIP effectiveness reviews, which also are conducted on a 3-year cycle.

The most recent reports (dated between June 1985 and May 1987) of these NAVSEA reviews at the eight SUPSHIPS showed that, generally, no significant problems were found with the claims avoidance programs. However, the reports identified inadequate staffing in programs at the New Orleans and San Diego SUPSHIPS in February 1986; recommended in December 1986 that a claims avoidance monitor be established by the Pascagoula SUPSHIP at all area shipyards having Navy-administered contracts; and in May 1987 recommended that the Groton SUPSHIP incorporate REA/claims reporting requirements in its local instruction.

Adequacy of Staffing at SUPSHIP Activities

During our review, the Groton, Long Beach, New Orleans, and San Diego SUPSHIPS and the Portsmouth detachment at Pennsylvania Shipbuilding told us that their staffing levels were inadequate to carry out oversight functions. SUPSHIP officials at two locations were particularly concerned.

An official of the New Orleans SUPSHIP told us the workload over the past 2-1/2 years increased 600 percent while the staffing increased 50 percent. Since 1983, contract dollars increased from $330 million to $2.2 billion in 1987, and the number of locations where contracts are being performed have increased from two to five. According to a San Diego official, that activity is understaffed, especially in the new construction area, and does not have sufficient staff to accurately monitor the recently awarded AOE-6 contract.

SUPSHIPS operate on a NAVSEA-approved "Management by Payroll" budget in which the number of personnel at a location are converted into budget dollars. NAVSEA headquarters attempts to match ship programs to planned oversight functions of each SUPSHIP by using the Five Year Defense Plan and the anticipated exercise of contract options for new construction.

Our analysis of the Authorization Expense Operating Budget distribution for SUPSHIPS for the fiscal years 1985-87 period showed that budgeted amounts for the most part had not changed significantly. Budgets for the Long Beach, New Orleans, and Portsmouth SUPSHIPS experienced year-to-year increases. Budgets for Bath and Pascagoula increased slightly from 1986 to 1987. On the other hand, budgets at the San Diego, Groton, and Newport News SUPSHIPS decreased in fiscal year 1987.

According to a NAVSEA official, it is difficult to accurately forecast where construction contracts will be awarded and, therefore, SUPSHIPS frequently have additional work that can upset staffing projections. Some SUPSHIPS can be understaffed until changes are made to meet the unanticipated work.

NAVSEA headquarters responds to unplanned/unbudgeted work by redistributing unobligated and overtime funds throughout the fiscal year, thus providing additional monies that can be used for additional staff.

We determined that NAVSEA headquarters, during mid-year and third quarter redistributions of fiscal year 1987 funds, responded to much of the SUPSHIPS' needs by providing for additional staff. A comparison of onboard staff at the beginning of fiscal year 1987 and end-of-year authorizations showed that levels at the eight SUPSHIPS were increased by 200. New Orleans and San Diego's authorized levels increased by about 18 percent and 3 percent, respectively.

Moreover, NAVSEA officials said that completion of contracts such as the T-AH hospital ship at San Diego also released staff for reassignment to new construction work. In addition, SUPSHIPS can use temporary staff pending the hiring of new staff. However, NAVSEA officials cautioned that, even though additional staff billets are authorized, SUPSHIP recruitment of people for some of the more remote locations can be a problem.

(394204)

(Source: Shipbuilders Council of America, October 1988)

LOW-INTEREST, LONG-TERM FINANCING ENHANCES SHIPYARD COMPETITIVENESS

Most of the top-ten shipbuilding nations of the free world make available long-term, low interest loans to ship buyers for a substantial percentage of ship cost at a low rate of interest. The emphasis on this type of financial assistance, however, varies from country to country.

Member countries of the Organization for Economic Cooperation & Development (OECD) are supposed to subscribe to the provisions of the OECD Understanding on Export Credits for Ships, which limits loans for export ships to 80 percent of the ship, repayable at a maximum of 8½ years from delivery, at a minimum interest rate of 8 percent per year. (Of course, if commercial rates are below 8 percent, then the commercial market would provide ship financing.)

According to a report in Shipping & Trade News, Sept. 2, 1987, Japan has repeatedly proposed that the OECD lower its credit terms to reflect lower worldwide interest rates, and an article in the Oct. 7, 1987, issue of the same magazine reported that Japan's Export-Import Bank had financed a contract last year between Hitachi Zosen and the Overseas Shipholding Group of the U.S. at 5 percent interest for two 260,000 dwt VLCCs. In general, however, Japan, Denmark, Italy, and Finland provide export credit terms at OECD rates. Germany offers 2 percent interest subsidies to bridge the gap with OECD rates.

Other kinds of ship financing with attractive terms offered in the world's top-ten ship producing nations are described below:

Japan (#1) - To encourage the construction of highly modernized oceangoing vessels such as containerships and LNG carriers, the Japan Development Bank (JDB) provides Japanese shipowners with 60 percent financing, repayable over 10 years after a 3-year grace period. The interest rate during the first part of 1988 was 5 percent. Private banks cover 20-40 percent of the ship's cost at the prime rate.

For other types of ships, the JDB provides 50 percent financing with commercial banks covering 25 percent. (JDB's financial resources are capital borrowings from the government and the capital market.) For Japan's FY 1987, the government provided $518.5 million through the JDB for the purchase of highly modernized ships, as well as funding $64 million in export credits through the Export-Import Bank.

South Korea (#2) - Loans to shipowners have been available in Korea to cover 90 percent of the shipbuilding cost (92 percent for a containership), with repayment for local funds (covering 70 percent of construction) at 10 percent interest over 8 years, with a 2½-year grace period. There are indications, however, that these programs are under review and have lead to reports of options ships cancelled by South Korean shipyards.

West Germany (#3) - Under certain conditions, West German shipowners can receive interest-free loans until 1990. In 1987, the West German government provided $84.8 million for this purpose. The government also provides interest subsidies (2 percent in 1987) for loans to build ships for export to developing countries. The 1987-1989 budget for this purpose is approximately $258.6 million

Brazil (#4) - A number of financial packages offering extremely favorable terms is offered by Brazil to entice both local and foreign owners to buy Brazilian ships. One of these schemes features the buyer obtaining a foreign bank loan on which the Bank of Brazil pays the interest.

Spain (#5) - Loans are available to cover 85 percent of the cost, repayable in 12 years with a 2-year grace period. The minimum interest rate is 8 percent, except for fishing vessels, which is 11 percent.

Denmark (#6) - As a temporary measure to encourage ship orders at Danish and EEC yards, offered 80 percent credit for ships ordered by the end of 1986 and delivered before the end of 1989, with repayment at 8 percent over 14 years, including a 4-year grace period. Various Danish shipping firms own six big shipyards in Denmark that employ about 75 percent of the total shipbuilding labor force.

The Netherlands (#7) - The Dutch government can provide an interest subsidy when the need exists. From 1980 through 1985, for example, $267.8 million in interest subsidies was provided. Currently, because the market interest rate is below 8 percent, ship financing is a commercial matter tied to commercial financing.

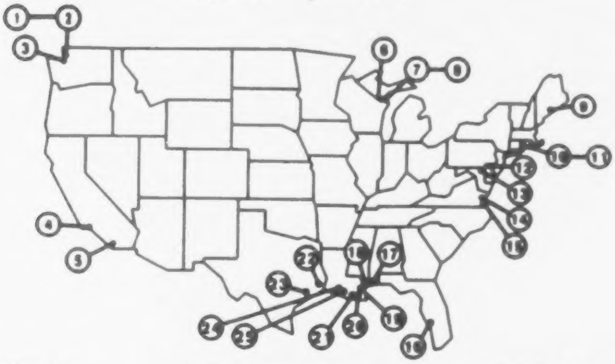
Italy (#8) - Fifteen-year loans authorized by the appropriate Italian government office can be made for up to 70 percent by the Instituto Mobiliare Italiano and other financial institutions for the construction, modernization, and repair of ships. If the Italian government determines that a need exists, temporary incentives are provided to Italian shipowners to purchase ships. Since 1982, for example, Law 261 provides for interest subsidies of 2.75 to 3.2 percent over 12 years. Interest subsidy funds were approximately $97.4 million in 1986. (Approximately 90 percent of the shipbuilding in Italy is owned and operated by FINCANTIERI, a holding company in which IRI, an agency of the Ministry of State Holdings owns 100 percent of the stock.)

Finland (#9) - To promote the acquisition of small ships suited for inland and coastal transport or for foreign trade, Finland provides interest subsidies.

Taiwan (#10) - For the 4-year Ministry of Communications program in Taiwan for the construction of 32 ships, public financing is provided at 80 percent, repayable over 12 years at 8¼ percent interest.

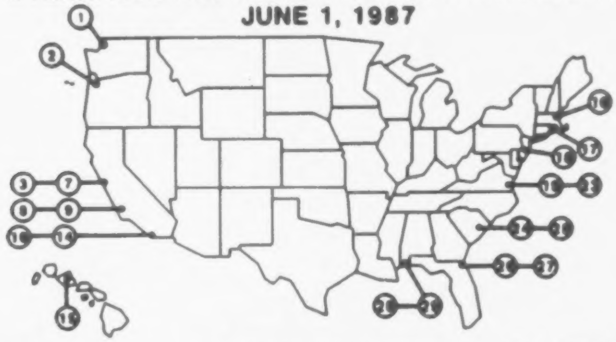
SHIPBUILDERS COUNCIL OF AMERICA
PRESS CONFERENCE
November 5, 1987

ACTIVE U.S. SHIPBUILDING BASE
JUNE 1, 1987



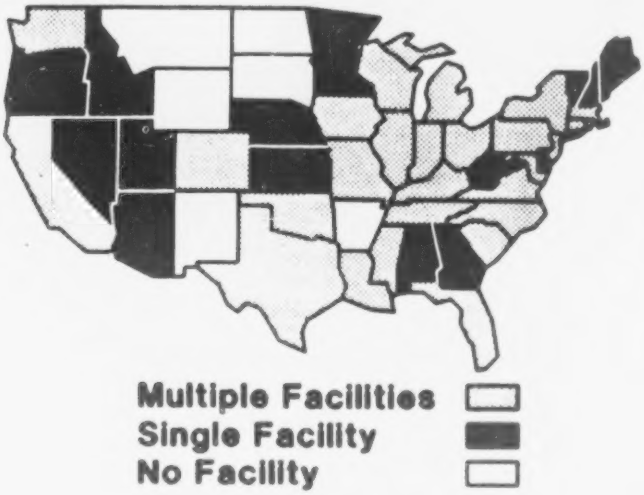
1. Todd-Seattle
2. Lockheed SB
3. Tacoma Boat
4. Todd-Los Angeles
5. National Steel
6. Marinette
7. Bay SB Corporation
8. Peterson
9. Bath Iron Works
10. R E Derecktor
11. GD-Electric Boat
12. Penn Ship
13. Beth-Sparrows Point
14. Newport News
15. Norfolk SB & DD
16. Tampa Ship
17. ADDSCO Industries
18. Litton-Ingalls
19. Avondale Shipyards
20. McDermott
21. Halter
22. Beth-Beaumont
23. Todd-Galveston
24. Textron
25. Moss Point Marine

PRIVATE SHIPYARDS HOLDING CONTRACTS FOR NAVY OVERHAULS AND MAJOR REPAIR AVAILABILITIES
JUNE 1, 1987

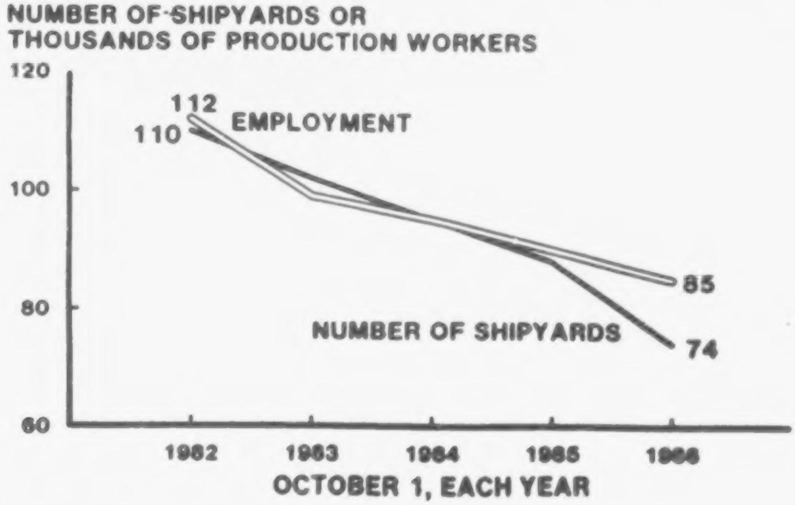


1. Todd-Seattle
2. Northwest Marine
3. Pacific Drydock
4. Continental Maritime, SF
5. Service Engineering
6. Todd-San Francisco
7. Southwest Marine, SF
8. Al Larson Boat
9. Southwest Marine, SP
10. National Steel
11. Campbell Industries
12. Arcwell Corp
13. Continental Maritime, SD
14. Southwest Marine, SD
15. Marisco Ltd
16. General Ship
17. GD-Electric Boat
18. Hoboken Shipyard
19. Jonathan Corp
20. Moon Engineering
21. Norfolk SB & DD
22. Metro Machine
23. Newport News
24. Detyens
25. Metal Trades
26. Jacksonville Shipyards
27. Atlantic Drydock
28. ADDSCO
29. Bender Shipbuilding

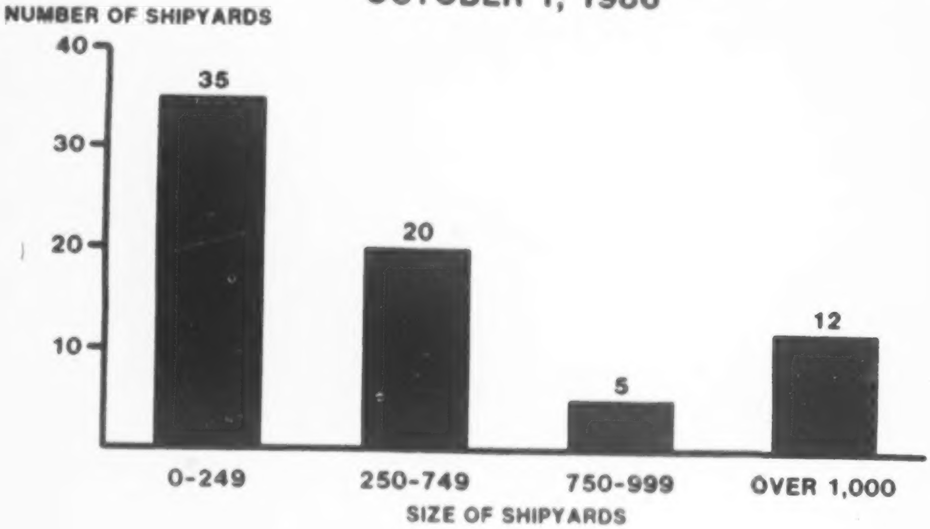
STATES CONTAINING THE MAJOR MANUFACTURERS OF MACHINERY AND COMPONENTS FOR THE U.S. SHIPBUILDING AND SHIP REPAIR INDUSTRY


Multiple Facilities ▨
Single Facility ■
No Facility ☐

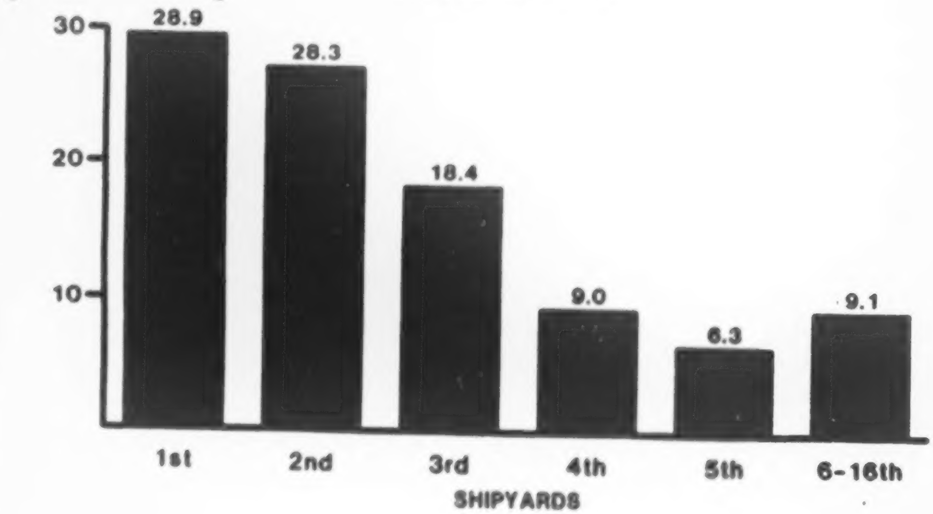
PRIVATE U.S. SHIPYARD BASE



EMPLOYMENT DISTRIBUTION FOR THE US. PRIVATE SHIPYARD BASE OCTOBER 1, 1986



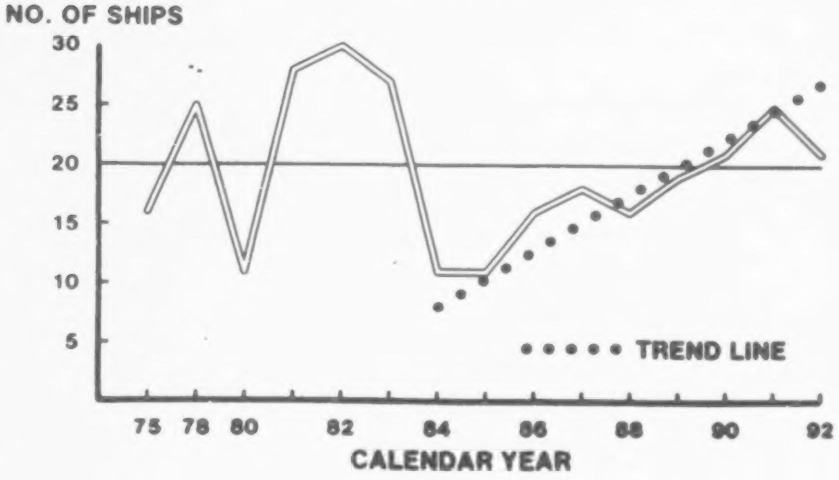
DISTRIBUTION OF SCN DOLLARS TO SHIPYARDS BY PERCENT OF TOTAL OUTSTANDING CONTRACTS JUNE 1, 1987



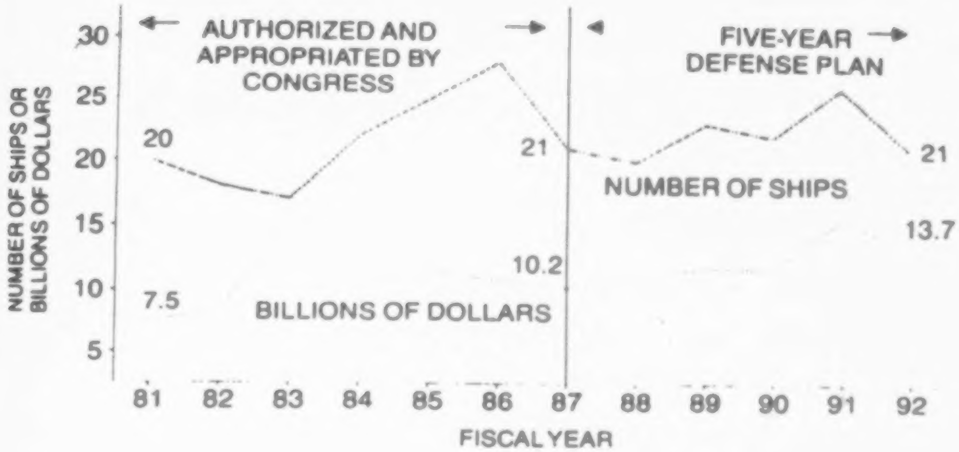
THE NAVAL SECTOR

- Historical SCN Overview
- SCN Future
- Navy Financing Actions
- Summary

NUMBER OF SHIPS ORDERED BY YEAR
(NAVY)



NAVY SHIPS APPROPRIATED OR PLANNED FOR U.S. PRIVATE SHIPYARDS



SUSTAINING THE 600 SHIP NAVY

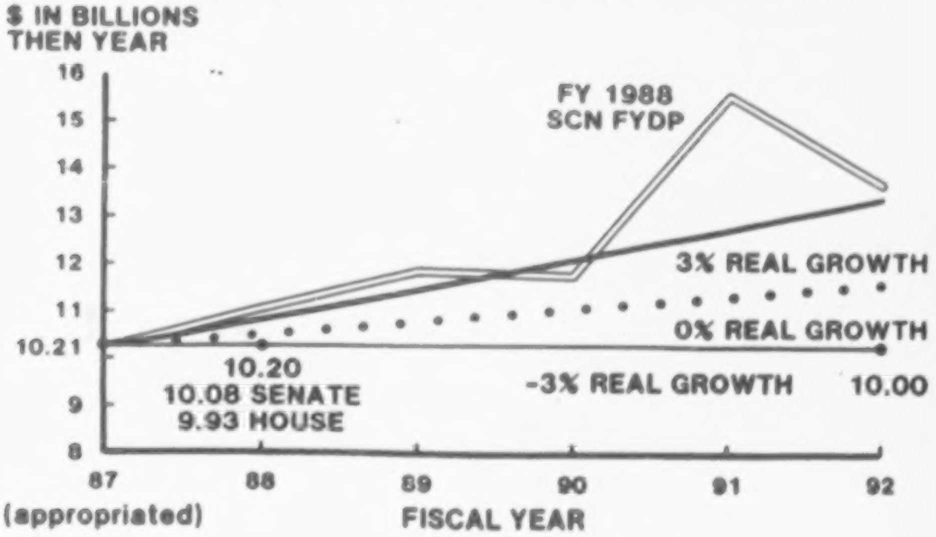
Ship Type	Required Number of Ships	Anticipated Service Life	Sustaining Building Rate
Ballistic Missile Submarines	25	30	1 Per Yr
Aircraft Carriers	15	45	1 Every 3 Yrs
Battleships	4	15-20	-
Antiair Cruisers/Destroyers	100	30-35	10 Every 3 Yrs
Antisubmarine Warfare Destroyers	37	30-35	1+ Per Yr
Frigates (FF/FFG)	101	30-35	10 Every 3 Yrs
Nuclear Powered Attack Submarines	100	30	10 Every 3 Yrs
Mine Countermeasures Ships	14	30	1 Per Yr *
Amphibious Ships	75	35-40	2+ Per Yr
Patrol Combatants	6	25	(As Class)
Combat Logistics Ships	65	40-45	1-2 Per Yr
Support Ships/Other Auxiliaries	60	40-45	1-2 Per Yr
	602		18 Yr

* Includes MHC, Not Counted in Deployable Forces

MINIMUM SCN REQUIREMENT

	Sustaining Building Rate	Annual Average Cost
Ballistic Missile Submarines	1 Per Year	$ 1.5 B
Aircraft Carriers	1/3 Per Year	$ 1.2 B
Battleships	-	-
Antiair Cruisers/Destroyers	3 1/3 Per Year	$ 2.3 B
Antisubmarine Warfare Destroyers	1 Per Year	$ .5 B
Frigates	3 1/3 Per Year	$ 1.0 B
Nuclear Powered Attack Submarines	3 1/3 Per Year	$ 2.7 B
Mine Countermeasures Ships	1 Per Year	$ .1 B
Amphibious Ships	2+ Per Year	$ 1.0 B
Patrol Combatants	(As Class)	-
Combat Logistics Ships	1-2 Per Year	$ .4 B
Support Ships/Other Auxiliaries	1-2 Per Year	$ .3 B
Outfitting/Post Delivery/Craft	-	$ .5 B
		$11.5 B

REAL GROWTH OPTIONS VS. FY 1988 NAVY SHIPBUILDING PLAN



DIFFERENCES BETWEEN FIVE YEAR SHIPBUILDING PLAN AND THE NEGATIVE 3% REAL GROWTH CURVE

FY 1988	FY 1989	FY 1990
-$860 Million	-$1.75 Billion	-$1.63 Billion

FY 1991	FY 1992
-$5.55 Billion	-$3.75 Billion

Total for Five Years: $13.64 Billion
Reduces President's Request by
21.3 Percent

NAVY SHIP MAINTENANCE AND MODERNIZATION ($ In Millions)

Total Appropriation

FY 1986	FY 1987	FY 1988	FY 1989
$4,688.2	$5,106.9	$4,168.8	$4,461.8

Dollars to Private Sector

FY 1986	FY 1987	FY 1988	FY 1989
$1,553.2	$1,722.2	$1,596.3 (Planned)	$1,808.6 (Planned)

NAVY FINANCING ACTIONS

Navy Squeezing Industry to the Brink

- Progress Payments
- Retentions
- Wage Rates Limited to 3.5% Growth
- Intensive Review of Profitability
- Discouragement of DOD Support for Capital Investment (CAS-414)
- Price Only Award Criteria

PROJECTIONS

- Decreasing Funding for Navy Shipbuilding
- Ability of Funds to Sustain 600 Ship Navy
- Navy Continues to Play Fiscal Hardball
- More Yards to Close, Further Weakening Industrial and Competitive Bases

DEFENSE DEPARTMENT'S POSITION

The Navy's current and planned shipbuilding and repair programs are, by themselves, insufficient to support the Nation's present shipyards at an efficient level of production...clearly what is needed is a revitalization of the commercial segment of the maritime industry.

Caspar Weinberger
April 10, 1985

THE COMMERCIAL SECTOR

- Cyclical in Nature
- Responds to Stimuli
- Industry Has Been Exported
- Administration Actions
- Summary

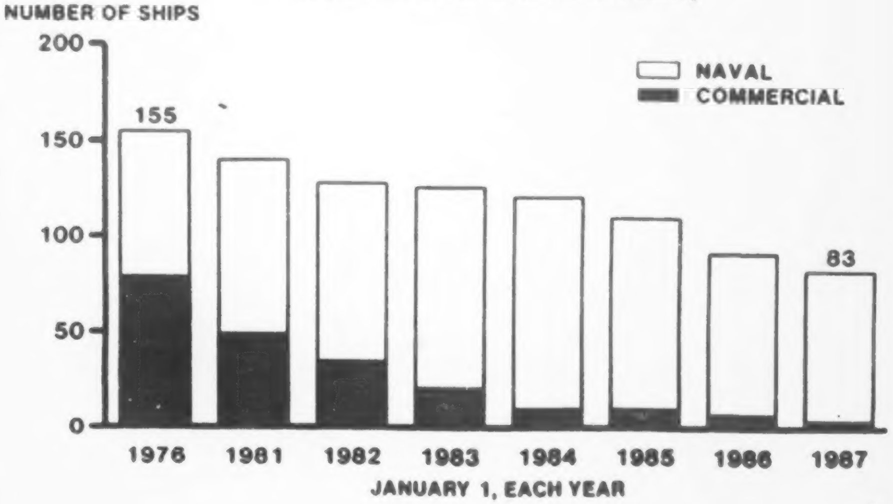
MERCHANT MARINE ACT, 1936
DECLARATION OF POLICY

National defense, foreign and domestic commerce require the United States to have a merchant marine:

- Sufficient to carry its domestic water-borne commerce and a substantial portion of its foreign water-borne commerce;
- Capable of serving as a naval and military auxilary in time of war or national emergency;
- Owned and operated under United States flag by citizens of the United States;
- Composed of best-equipped, safest,and most suitable types of vessels, constructed in United States; and
- Supplemented by efficient facilities for shipbuilding and ship repair.

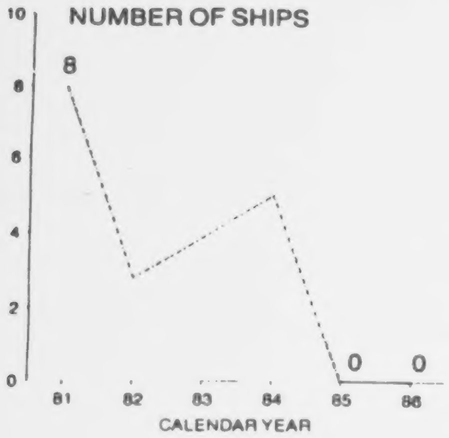
Secretary of Transportation (Maritime Administration) is responsible for implementing this policy.

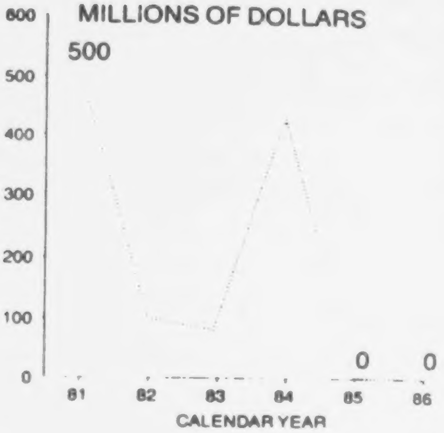
NUMBER OF NEW COMMERCIAL AND NAVAL SHIPS UNDER CONSTRUCTION OR ON ORDER IN U.S. PRIVATE SHIPYARDS (1,000 TONS AND LARGER)



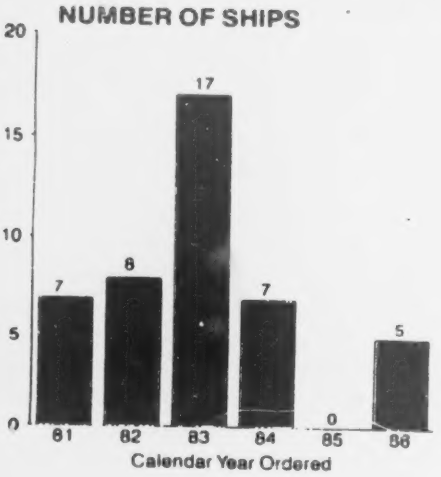
COMMERCIAL SHIP ORDERS PLACED WITH U.S. PRIVATE SHIPYARDS

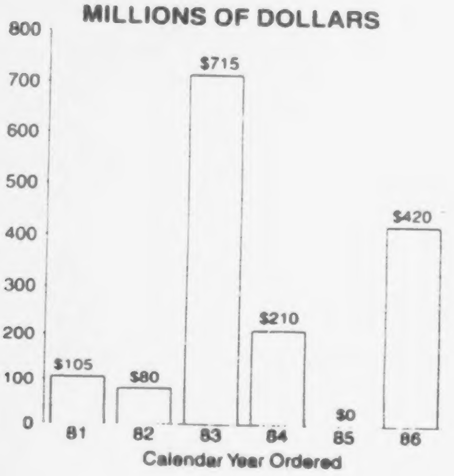
(1,000 TONS AND LARGER)



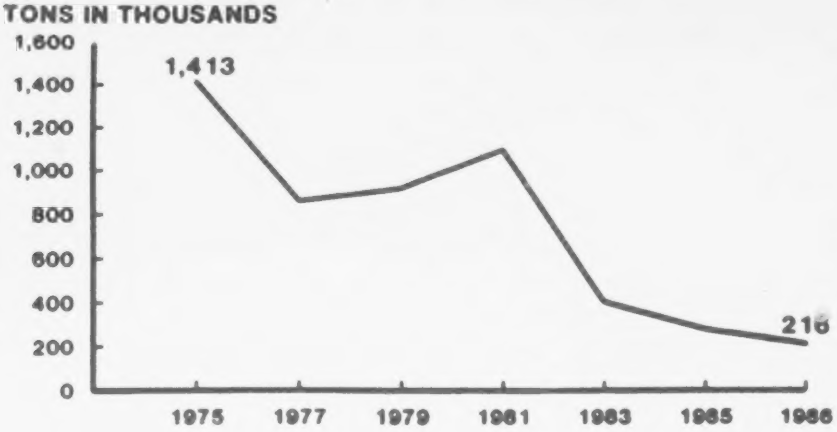


FOREIGN BUILT SHIPS FOR ODS OPERATORS





ANNUAL SHIPMENTS OF U.S. FINISHED STEEL TO SHIPBUILDING & MARINE EQUIPMENT INDUSTRY



POLICY DECISIONS UNDERMINING SHIPBUILDING BASE

DECISION	RESULT
• Failure to Fund Construction-differential Subsidy Program	• No Vessels for Foreign Trade Have Been Built in U.S. Shipyards
• Permit Subsidized U.S. Flag Operators to Build or Acquire Vessels Overseas	• Same as Above
• Permit Exportation of Alaskan Crude Oil	• Create Uncertainty in Coastwide Market Causing Operators Not to Order New Vessels from U.S. Shipyards

POLICY DECISIONS UNDERMINING SHIPBUILDING BASE
(Continued)

DECISION	RESULT
• Repayment of Construction-differential Subsidy by Large Tanker Operators so as to Engage in Alaskan Crude Oil Trade	• Create Uncertainty in Coastwide Market Causing Operators not to Order New Vessels From U.S. Shipyards
• Seek Elimination of the Title 11 Federal Ship Mortgage Guarantee Program	• Reduce Shipbuilding Opportunities for Domestic Shipyards
• Remove 50 Percent Domestic Content Requirement for Vessels Built for Coastwide Trade	• Adversely Affect Vendors of Marine Equipment

FUTURE FOR COMMERCIAL SHIPBUILDING AND REPAIR ABSENT A PROGRAM

- No Vessels Built in Shipyards for Foreign Trade
- Limited Number of Replacement Opportunities for Dry Cargo Vessels in Domestic Offshore Trade
- Tankers Built in Shipyards for Coastwide Trade Dependent on Oil Development of Arctic National Wildlife Refuge
- Limited Opportunities for Repair and Conversion
  - Breakdowns and Accidents
  - Upgrade Vessels Acquired for Ready Reserve Force

PROJECTIONS FOR COMMERCIAL SHIPBUILDING AND REPAIR

- Additional Shipyards Will Close
- Limited Number of Repair Yards Located in Major Ports Will Survive

CONCLUSIONS

- Shipbuilding Industry is Shrinking and Has Only One Customer - The Navy
- Future Navy Budget Levels Are Questionable Due to Deficit Reduction Issues
- The Industry Cannot Support Industrial Mobilization Base Requirements
- Merchant Marine Cannot Support Defense Department Requirements for Sealift or Mariners for Ready Reserve Fleet

GENERAL ISSUES

- Support the Navy Shipbuilding and Ship Repair Budgets
- Create a Fair Trade Environment for Shipbuilding
- Develop a Commercial Shipbuilding Program
- Support an Expanded Foreign Military Sales Effort
- Preserve the Integrity of the Jones Act
- Minimize Disruption of Defense Procurement Policies Affecting Cash Flow and Profitability

Legislative Issues

GENERAL ISSUE

SUPPORT THE NAVY SHIPBUILDING AND SHIP REPAIR BUDGETS

SPECIFICS

- Authorization for Shipbuilding Programs
  A. House
  B. Senate
- Authorization for Ship Repair Programs
  A. House
  B. Senate
- Expected Appropriation Actions
- Impact of Continuing Resolutions
- Level Playing Field for Public-Private Repair Competition

GOAL

- Maintain Single, Most Critical Market for Shipbuilders

Legislative Issues

GENERAL ISSUE

CREATE A FAIR TRADE ENVIRONMENT FOR SHIPBUILDING

SPECIFICS

- Support Trade Legislation Tightening Administrative Procedures of Special Trade Representative
- Section 301 of 1974 Trade Act Defines Foreign Shipbuilding Subsidies as Unfair
- Establish Shipbuilding Intervention Fund to Counter Foreign Practices Where Behavior is Unchanged Following Negotiations

GOAL

- Stop Export of Shipbuilding Jobs

Legislative Issues

GENERAL ISSUE

DEVELOP A COMMERCIAL SHIPBUILDING PROGRAM

SPECIFICS

- Create Market Stimulus for U.S. Construction of U.S. Flag Bulk Fleet in Foreign Commerce
- Economic Analysis Indicates Strengthening of Tanker Demand

GENERAL ISSUE

DEVELOP A COMMERCIAL SHIPBUILDING PROGRAM

SPECIFICS (CONT'D)

- Government Support to Offset Foreign Price Advantage
  - Direct Procurement of Product Carriers for Charter to Private Operators
  - Preference for U.S.-Built Tonnage in Import Trades
  - Tax Credits to Shippers to Offset Use of U.S.-Built Tonnage
- Defense Need in Excess of 120 Tankers

GOAL

- Revitalization of U.S.-Built, U.S. Flag Bulk Fleet
- Maintenance of Industrial Base

Legislative Issues

GENERAL

SUPPORT AN EXPANDED FOREIGN MILITARY SALES EFFORT

SPECIFICS

- U.S. Shipbuilders Expertise is Naval Construction
- Develop Joint Venture with Government to Penetrate Market
- Allow Foreign Selling Costs to be Recovered in Government Contract Overhead Rates
- Streamlined, More Responsive Administrative Process to Approve Export Licenses
- Assist DSAA in Increasing FMS Budget Resources
- Work with Government to Identify Potential Markets and Financing Options
- Participate in Joint Design Efforts to Develop Product for Foreign Markets

GOAL

- Penetrate International Market as a Method to Sustain Present Capacity

Legislative Issues

GENERAL ISSUE

PRESERVE THE INTEGRITY OF THE JONES ACT

SPECIFIC ISSUES

- Minimize Uncertainty Surrounding Market Conditions
- Oppose Promulgation of CDS Re-payment Regulation
- Oppose Exportation of Domestic Sources of Petroleum
- Potential Exists for Near Term Orders if Demand Forms and Administrative Policies do not Affect Market Structure

GOAL

- Most Nations Protect Domestic Trades and Jones Act Represents Only Potential Commercial Market Absent Direct Government Financial Support

Legislative Issues

GENERAL ISSUE

MINIMIZE DISRUPTION OF PROCUREMENT POLICIES AFFECTING CASH FLOW AND PROFITABILITY

SPECIFIC ISSUES

- Repeal Progress Payment Reductions
- Oppose Re-establishment of Profit Review Mechanisms
- Legislate Easing of Administrative Burdens on Retentions
- Direct DOD Implementation of Prompt Payment Procedures
- Cease Procurement Policy Re-write Efforts

GOAL

- Re-establish Positive Cash Flow, Reduction in Risk, and Profitability

FINDINGS OF THE PRESIDENT'S COMMISSION ON MERCHANT MARINE AND DEFENSE

The Commission has Found Clear and Growing Danger to the National Security in the Deteriorating Condition of America's Maritime Industries

FINDINGS (Continued)

- **Insufficient U.S. Sealift Exists in Both Ships and Personnel to Execute a Major Contingency Deployment in a Distant Theater**
- **Rate of Decline of Maritime Industries is Increasing at an Alarming Rate**
- **Allied Merchant Shipping is Also Declining**
- **Emphasis on Bid Price Rather than Value has Harmed Merchant Marine and Shipbuilding and Repair Base**

FINDINGS (Continued)

- "Free Trade" does not Exist
- Jones Act, Cargo Preference Act and Military Cargo Preference Act are Essential
- Navy Construction and Repair Work is Insufficient to Maintain Adequate Industrial Base to Meet Mobilization Needs

FINDINGS (Continued)

- Commercial Shipbuilding has Collapsed
- Heroic Measures Necessary to Reverse the Decline
  - Government Leadership is Required
- Allocation of National Resources will be Required to Pay for Defense Aspects